88-657

No. .....

Supreme Court, U.S.
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In The
Supreme Court of the United States
October Term, 1988

—o—

CHARTER MEDICAL CORPORATION,
Petitioner,
vs.
JEROME S. CARDIN, JEROME J. COLLER, M.D. and KENNETH E. HANSEN,
Respondents.

—o—

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

—o—

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QUESTION PRESENTED

Does section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l* (1982), require the controlling shareholders of a corporation, the stock of which is held by the public, to disclose as material facts to the purchaser of their shares the participation of the corporation's president and chief financial officer in a scheme to inflate sales and falsify the corporation's financial statements, and the resulting decision by the controlling shareholders to fire the chief financial officer and isolate the president from financial responsibility until he could be fired?

PARTIES

The following persons and entities were parties to the proceedings in the district court and court of appeals: Charter Medical Corporation (Plaintiff-Petitioner "Charter"); Jerome S. Cardin, Jerome J. Coller, M.D. and Kenneth E. Hansen (the "defendants"); and Morton D. Goldman, Stanley E. Krosin, Edward Raskin, Alexander Grant & Co., George Abdow, Gerald I. Moskowitz, and the law firm of Cardin & Cardin, P.A. (Third-Party Defendants). Only Messrs. Cardin, Coller and Hansen are the subjects of this Petition.

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OPINIONS BELOW

The Fourth Circuit Court of Appeals' opinion sought to be reviewed, which is referenced at 850 F.2d 688, and the Fourth Circuit's denial of the petitioner's motion for rehearing and suggestion of rehearing en banc appear in the Appendix. The decision on the merits under Fed. R. Civ. P. 41(b) by the district court, which was expressly adopted by the court of appeals as the basis of its decision on the matter at issue here, is also included in the Appendix, along with other relevant materials from the record.

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JURISDICTIONAL STATEMENT

The decision of the Court of Appeals for the Fourth Circuit was entered on June 17, 1988. The Fourth Circuit denied Petitioner's Petition for Rehearing En Banc and Motion for Rehearing on July 20, 1988. This Court's jurisdiction is invoked under 28 U.S.C. § 1254.

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STATUTE INVOLVED

Any person who—

* * *

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospec-

> tus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l*.

STATEMENT OF THE CASE

This is an action by Charter against Messrs. Cardin, Coller and Hansen (sometimes referred to collectively as the "defendants") for damages sustained by Charter in connection with its purchase from those individuals of 25% of the outstanding stock of a company known as Psych Systems, Inc. ("Psych Systems").

At the time of Charter's stock purchase in June 1984, Psych Systems was a corporation whose stock was publicly owned and which was subject to the registration, reporting and proxy solicitation requirements of the federal securities laws. The defendants were the controlling shareholders and senior executive officers of Psych Systems,

and constituted three of the four members of the executive committee of its board of directors.

The primary claims adjudicated below were Charter's claims against the defendants for misrepresentations and omissions under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l* (1982), § 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*r* (1982), and § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The most important fact relating to Psych Systems that was *admittedly* not disclosed to Charter at the time of Charter's negotiations for and purchase of the defendants' Psych Systems stock was that, during the audit of Psych Systems' most recent financial statements for the fiscal year ending November 30, 1983, Psych Systems' auditors, Alexander Grant & Co., had discovered a fraudulent scheme perpetrated by Psych Systers' president and chief financial officer to falsely inflate its year-end sales and falsify its year-end financial statements. As a result of this discovery and its disclosure to the defendants in February 1984, almost $1,000,000 of supposed sales included in Psych Systems' original November 30, 1983 financial statements (out of total sales for the year of approximately $5,000,000) were reversed by the auditors, changing Psych Systems' fiscal year 1983 operating results from showing a small profit to a loss of approximately $1.2 million. (App. 23). As a result of the auditors' recommendation to the defendants that the president and the chief financial officer be fired, the defendants terminated Psych Systems' chief financial officer, Walter Wilowatyj, and decided to isolate its recently promoted president and newly appointed director,[1] Gerald Mosko-

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[1]Mr. Moskowitz was the fourth member of the executive committee of Psych Systems' board of directors.

witz, from financial responsibility until he could also be terminated.

At that same time, the defendants knew that Mr. Moskowitz was engaged in merger negotiations with Charter on behalf of Psych Systems. These negotiations ultimately resulted in the defendants' sale of their Psych Systems stock to Charter. The defendants also knew, prior to their stock sale, that Charter regarded Mr. Moskowitz as a key employee and that it intended to retain him as Psych Systems' president after the stock purchase and anticipated merger.[2]

On June 8, 1984, Charter and the defendants executed a written Stock Purchase Agreement under which Charter purchased the defendants' 371,919 shares of Psych Systems' stock representing 25% of the total outstanding shares. (App. 5). Charter paid the defendants $1,301,716.50 for their stock and agreed to pay them an additional $557,878.50, if and when Charter's proposed acquisition of the remainder of Psych Systems' stock was consummated. As a part of this Stock Purchase Agreement, the defendants acknowledged having provided Charter with Psych Systems' Annual Report on Form 10-K for the fiscal year ending November 30, 1983 (filed with the SEC on March 14, 1984), Psych Systems' Quarterly Report on Form 10-Q for the quarter ending February 28, 1984 (filed with the SEC on April 13, 1984) and Psych Systems' Annual Proxy Statement (filed with the SEC on April 4, 1984).[3] In sec-

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[2]Indeed, in their brief in the court of appeals, the defendants candidly admitted that "Charter would not have acquired the [Psych Systems] stock if it had known that Mr. Moskowitz was dishonest." Brief p. 29.

[3]Mr. Moskowitz' December 1983 appointment as a director and a member of the executive committee of Psych Systems' board of directors was one of the subjects of the Proxy Statement.

tion 5 of the Stock Purchase Agreement the defendants expressly warranted that all of the documents filed with the SEC fully disclosed all material facts regarding Psych Systems. (App. 51-54). However, nothing was disclosed in any of these documents (or in any other manner) about Mr. Moskowitz' role in the recent false sales scheme, his being "isolated from financial responsibility," the firing of the chief financial officer, Mr. Wilowatyj, or anything else about the false sales scheme.

The defendants' knowledge of the scheme and Mr. Moskowitz' involvement was clearly established, as the district court acknowledged in its opinion. (App. 17). Not only were the defendants told by Alexander Grant representatives in February 1984 that Messrs. Moskowitz and Wilowatyj were involved and should both be fired, they had *independent* knowledge reflected in written memos sent among them at the time. For example, Dr. Coller wrote Mr. Cardin in March 1984:

> I was further told by Renie Dunie[4] and Lee Richards[5] that *Moskowitz had told each of them separately that he would be able to pull off that inflated sales report because the auditors were "too dumb to pick it up."* I have concerns that knowing all of this keeping Moskowitz in a place of responsibility where he can make decisions or commitment that adversely affect the Company subjects me to legal exposure. Yet he has certain successful endeavors with the Company in relation to customer relations—sales in the industrial market that make his presence critical at this time.

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[4]Renie Dunie was a Psych Systems employee responsible for processing sales orders.

[5]Lee Richards was president of Psych Systems' leasing subsidiary.

> Knowing all of this, I think he should stay but needs very careful watching.

(Emphasis added). (App. 41).

Instead of being "isolated" or "watched carefully" as Alexander Grant had been promised, however, Mr. Moskowitz was allowed to continue as a director and as president and chief operating officer, and continued to supervise directly Psych Systems' operations and finances. Mr. Moskowitz was also allowed to continue negotiating with Charter about a proposed acquisition, which ultimately resulted in Charter's purchase of the defendants' stock.

Within a few months after Charter acquired the defendants' stock, Charter discovered the false sales scheme and called off the proposed acquisition of the remainder of Psych Systems' stock.[6] Pressed by its creditors, Psych Systems filed for protection under Chapter 11 and was ultimately liquidated.

At the close of Charter's evidence in a non-jury trial, the district court granted the defendants' motion for judgment under Rule 41(b) of the Federal Rules of Civil Procedure. The sole basis of the district court's judgment on Charter's § 12(2) claim relating to the failure to disclose management misconduct was its conclusion that the omitted

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[6]Charter also discovered a substantial amount of false sales still included in Psych Systems' November 30, 1983 and February 28, 1984 financial statements. These false sales were deemed immaterial by the district court and the Fourth Circuit in light of Charter's admitted knowledge of Psych Systems' poor financial condition in June 1984.

facts regarding management misconduct were not material.[7] The only reason given by the court for this conclusion was its finding that Charter knew, at the time of its purchase, that Psych Systems was in bad financial condition and that it had been poorly managed.[8] (App. 16). Basically, the district court concluded that management misconduct in and of itself was immaterial, as a matter of law, unless it had an immediate material *financial* impact on the company.

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[7]Materiality is an *objective* standard—whether a "reasonable investor" would consider the information in question important. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976). The *subjective* test of whether information is important to a *particular* investor (essentially whether a particular investor *relied* on the information) should be irrelevant to Charter's § 12(2) claim. *Adalman v. Baker, Watts & Co.*, 807 F.2d 359, 373 (4th Cir. 1986) (no need for each individual plaintiff under § 12(2) to show that misrepresentations and omissions were material to their individual decisions).

[8]The district court made two other observations regarding its conclusion that the undisclosed information about Mr. Moskowitz' involvement in the scheme to inflate sales was supposedly immaterial, neither of which address the real significance of his involvement—the obvious fact that no one would want to purchase a business to be run by a person it could not trust. The fact that the *defendants* apparently accepted Alexander Grant's recommendations, as the district court concluded, reinforces the materiality of the recommendations, rather than the contrary. That, once it was in control of Psych Systems and learned enough to suspect Mr. Moskowitz' involvement in wrongdoing, Charter was compelled to keep Mr. Moskowitz on as president until he could be replaced, is hardly relevant to whether a reasonable investor would have considered this information important *prior* to purchasing control. Similarly, the court's primary reason that Charter supposedly knew when it purchased the defendants' stock that Psych Systems had been poorly managed says nothing about how Charter would have reacted to the information prior to Charter's stock purchase that it had been *dishonestly* managed.

Charter appealed from this judgment in favor of Messrs. Cardin, Coller and Hansen. The Fourth Circuit affirmed in a decision that did not address the failure to disclose Mr. Moskowitz' wrongdoing and the false sales scheme (although this topic was the main subject of Charter's argument for reversal), but merely adopted the decision of the district court, and in particular, its determination that Mr. Moskowitz' wrongdoing, the scheme and the defendants' reaction to them were not material facts required to be disclosed under § 12(2).

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EXISTENCE OF JURISDICTION BELOW

The district court has federal jurisdiction pursuant to 28 U.S.C. § 1331 as a result of the questions of federal law presented by Charter's claims under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*.

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REASONS FOR GRANTING THE WRIT

The Supreme Court should grant the writ because the decision of the Fourth Circuit (as well as of the district court below) is contrary to decisions of this Court and in conflict with other circuit courts regarding the materiality of management misconduct and the obligation to disclose it under the federal securities laws.

This Court has repeatedly recognized the "heightened significance" of the concept of materiality under the fed-

eral securities laws. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 (1976); *Basic, Inc. v. Levinson*, 108 S.Ct. 978, 983 (1988). Consistent with that concern, just last term in the *Basic* case this Court clarified the manner in which the general standard of materiality should be applied to the disclosure of ongoing merger negotiations, and corrected a conflict between the circuits on this issue. The instant case involves another such conflict among the circuits and presents an important opportunity for clarification as to the materiality and need for disclosure of the existence of management misconduct to the investing public.[9]

The decision of the Fourth Circuit (and the district court) that upper management's falsification of financial information and the corporation's resulting decision to fire one member of upper management (the chief financial officer) and to "isolate" the other from financial responsibility (the president and a director) until he could be replaced is not material information that must be disclosed to current shareholders, the S.E.C., or prospective

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[9]Materiality is of crucial significance to § 12(2) claims like this because, in order to recover under § 12(2), a plaintiff need prove *only* that the defendant seller of stock omitted to state a material fact and that the plaintiff had no knowledge of the omission. A plaintiff under § 12(2) need *not* prove (i) scienter, (ii) that the plaintiff relied in any way on the misrepresentation or omission, or (iii) causation. *Adalman v. Baker, Watts & Co.*, 807 F.2d 359, 373 (4th Cir. 1986); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970); *Currie v. Cayman Resources Corp.*, 835 F.2d 780 (11th Cir.), *reh'g denied*, 851 F.2d 399 (11th Cir. 1988); *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695-96 (5th Cir. 1971).

investors is contrary to the decisions of other courts of appeals. *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 25-26 (1st Cir. 1987) (reversing district court's holding that management participation in bribery scheme was not material until it became the likely subject of indictment); *Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1048 (2d Cir. 1985), *cert. granted and judgment vacated*, 478 U.S. 1015 (1986) (SEC investigation of fraud in connection with an investment similar to that offered petitioner is material information that should be disclosed); *Wilson v. Great American Industries, Inc.*, 855 F.2d 987 (2d Cir. 1988) (failure to disclose fraudulent acts of merging company's management in a prior transaction was a material omission); *SEC v. Washington County Utility Dist.*, 676 F.2d 218, 225 (6th Cir. 1982) (existence of a kickback scheme in connection with a securities offering is a material fact); *Alna Capital Assocs. v. Wagner*, 532 F. Supp. 591, 599 (S.D. Fla. 1982), *aff'd*, 758 F.2d 562 (11th Cir. 1985) (publishing false financial information is itself a material fact because it calls into question all management representations about the corporation).

These cases hold that facts adversely reflecting on management integrity are generally material, even assuming that the undisclosed facts had little immediate financial significance.[10] "Illegal payments that are so

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[10]Numerous courts have emphasized the materiality of management's past "track record" to prospective investors. *See SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1323-24 (11th Cir. 1982) (facts that individuals involved in forming new airline had been involved in prior airline failures, and other airline which flew the same routes as new airline that had just failed, were un-

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small as to be relatively insignificant to the corporation's bottom line can still have vast economic implications." *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987). "Furthermore, regardless of financial motives, investors may not want to associate themselves with such an enterprise." *Id.* at 25. *See SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 829-30 (E.D. Wis. 1978) (integrity of management is material apart from economic considerations).[11]

On the other hand, the instant decision appears to be in accord with decisions of the Ninth and Eighth Circuits and some district courts holding that management misconduct which does not involve self-dealing or have immediate material financial consequences is immaterial as a matter of law. *See Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); *Abbey v. Control Data Corp.*, 603 F.2d 724, 731 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Amalgamated Clothing*

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doubtedly material); *In re Catanella and E.F. Hutton and Co.*, 583 F.Supp. 1388, 1404 (E.D. Pa. 1984) (broker's failure to disclose track record of self-dealing, churning and mishandling of other portfolios is highly material); *Jenny v. Shearson, Hammill & Co.*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,911, at 90,633-634 (S.D.N.Y. 1981) (a brokerage firm's failure to disclose that it had previously disciplined an investment advisor may be material when that individual exercises considerable discretion, such as control over a discretionary account).

[11]Under the circumstances of the present case, where there was not dispute about the relevant facts, the court of appeals' review was not restricted to a clearly erroneous standard. *See Bose Corp. v. Consumer's Union of U.S., Inc.*, 466 U.S. 485 (1984) (Fed. R. Civ. P. 52(a) does not inhibit appellate court's power to correct errors of law, including those that may infect so-called mixed finding of law and fact, or a finding of fact that is predicated on a misunderstanding of the governing rule of law); *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970) (review unrestricted when evidence is undisputed).

and Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328, 332 (S.D.N.Y. 1979) *vacated as moot*, 638 F.2d 7 (2d Cir. 1980) ([I]t is "silly" and "unworkable" to expect corporate management to disclose its illegal or unethical acts.). *Cf. United States v. Matthews*, 787 F.2d 38 (2d Cir. 1986) (nondisclosure of uncharged criminal conduct not specifically required to be disclosed by S.E.C. rules cannot be the basis of a criminal prosecution.[12] As the *Gaines* court held:

> Absent credible allegations of self-dealing by the directors or dishonesty or deceit which inures to the direct, personal benefit of the directors—a fact that demonstrates a betrayal of trust to the corporation and shareholders and the director's essential unfitness for corporate stewardship—we hold that director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections. This type of mismanagement, unadorned by self-dealing, is simply not material or otherwise within the ambit of the federal securities laws. *Golub v. PPD Corp.*, 576 F.2d 759, 764-65 (8th Cir. 1978); *see Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221, 1222 (9th Cir. 1980). A contrary holding would place an unwarranted premium on the form rather than the substance of a shareholder's complaint and, moreover, would represent a move toward the federalization of corporate law that the Supreme Court has repeatedly and emphatically rejected.

Id. at 779. In other words, these courts have held that management misconduct purportedly inuring to the "benefit" of the corporation as opposed to management itself,

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[12]The *Roeder* court specifically refused to apply the reasoning of *Matthews* to the 10b-5 claim before it, noting that the Fifth Amendment concerns present in *Matthews* did not apply in a civil action. 814 F.2d at 26.

such as kickbacks to third-parties or, as here, falsely inflating sales, is never material information under the federal securities laws.

The result of this conflict was aptly summarized in a 1982 speech by John M. Fedders, Director of Enforcement of the Securities and Exchange Commission:

> There is a lack of developed case law in this residual area [of management misconduct not involving self-dealing or clearly having material financial consequences]. There are few guidelines to assist issuers when making disclosure determinations regarding [such] . . . information. This is particularly true of information regarding the integrity of corporate directors and officers. . . .

Nondisclosure of Illegal Behavior, [1982 Decisions Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,279, at p. 85,526 (Nov. 19, 1982). Moreover, the problem is a persistent and serious one which has prompted recent critical examination by public accounting groups. *See, e.g., Report of the National Commission on Fraudulent Financial Reporting*—October 1987 ("Treadway Commission Report").[13] This situation creates a pressing need for the Supreme Court to clarify the standards for determining materiality in the area of management misconduct as it did in the area of merger negotiations in *Basic.*

Indeed, the reasoning of *Basic* is directly applicable to the instant situation: the appropriate standard for determining materiality here, as there, is a "fact-specific inquiry" that takes into account all the relevant factors

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[13]The recommendations of the Treadway Commission include requiring a "management report" in the annual reports of all public companies. *Id.* at p.44 Such a report would have required disclosure of the management misconduct at issue here.

which establish the importance or lack of importance of the withheld information to a reasonable investor. *Basic*, 108 S.Ct. at 987-88. The standard is not the hard and fast rule applied here and in *Gaines* that deems management misconduct not involving self-dealing or immediate direct significant financial consequences immaterial as a matter of law. Simply put, the law should recognize that there is more to an investment decision than short-term financial considerations.[14] The inappropriateness of such a limitation to this case is conclusively established by the defendants' concession before the circuit court, noted in footnote 2, *supra*, that the information withheld here would have, in fact, been decisive to Charter's determination whether to buy the defendants' Psych Systems' stock.[15]

The clear materiality of the management misconduct at issue here is also supported by the fact that Charter was purchasing the defendants' stock with the clear in-

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[14]Moreover, culpable conduct can have significant long-term financial implications, not immediately foreseeable. *See SEC v. Paradyne Corp.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,464, at 92,836 (M.D. Fla. 1985) (refusing to dismiss complaint by the SEC, reported at *SEC v. Paradyne Corp.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,138 (M.D. Fla. 1983), in which it was alleged that Paradyne had fraudulently sold a computer system to the U.S. Government, and had made materially misleading statements by not disclosing the contingent liabilities from such actions). *See Jos. Schlitz*, 452 F. Supp. at 830 (allegedly illegal marketing practices could be material in that they posed a threat to a company's licenses to sell beer, a major component of the business).

[15]The materiality of the information at issue here is also clearly demonstrated by the defendants' own response to it. Instead of ignoring Alexander Grant's warnings, the defendants terminated one member of management and took steps (ultimately unsuccessful, however) to "isolate" the other from finan-

(Continued on following page)

tention of retaining Mr. Moskowitz as Psych Systems' president. Under these circumstances, it strains reason to deem questions about his integrity—as opposed to his financial competence (assuming they are somehow distinguishable)—to be a mere academic inquiry.[16] It is contrary to the purposes of the federal securities laws to consider such misconduct immaterial in a § 12(2) case. As the authorities gathered in footnotes 7 and 9, *supra*, hold, § 12(2) is governed by the objective standards of the statute instead of subjective elements of common law fraud or Rule 10b-5 in which reliance and the characteristics and proclivities of the individual plaintiff are relevant. Surely the concerns of a "reasonable" investor include problems of management misconduct serious enough to warrant dismissal of one of the very senior officers involved.

As the Court emphasized in *Basic* regarding the federal securities acts in general:

> This Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.' "

108 S.Ct. at 982. This Court has made similar observations about the purpose of § 12(2):

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cial responsibility and to "watch him carefully." (App. 41). *See Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 922 (8th Cir. 1977) (reversing summary judgment for § 12(2) defendant where defendant investment brokers had failed to disclose that they had lowered their own inventory of a particular category of commercial paper).

[16]It also strains reason to relegate Charter to state law to attempt a recovery, as *Gaines* and its progeny would. Indeed, Charter would undoubtedly lack standing to bring a derivative action on account of Mr. Moskowitz' conduct—or the defendants' non-disclosure of it—because of Charter's not having been a shareholder at the time the events occurred.

> But the 1933 Act is intended to do more than ensure that defrauded investors will be compensated: the Act also "aim[s] . . . to place adequate and true information before the investor." . . . We may therefore infer that Congress chose a rescissionary remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure as well as to make investors whole.

Randall v. Loftsgaarden, 106 S.Ct. 3143, 3151 (1986). This philosophy and purpose are frustrated by rulings such as the lower courts rendered here which base the determination of materiality on the incorrect and inflexible assumption that a reasonable investor's legitimate concerns are limited solely to financial matters.

CONCLUSION

This Court should grant *certiorari* to resolve the conflict among the circuits with regard to the materiality of management misconduct under the federal securities laws and to protect the rights of securities purchasers, such as Charter, to full disclosure.

Respectfully submitted,

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

JEROME S. CARDIN, JEROME J. COLLER, and KENNETH E. HANSEN,	)	
Plaintiffs,	)	CIVIL NO. H-84-3714
vs.	)	(consolidated)
CHARTER MEDICAL CORPORATION,	)	
Defendant.	)	
CHARTER MEDICAL CORPORATION,	)	
Plaintiff,	)	
vs.	)	CIVIL NO. H-85-568
ALEXANDER GRANT & CO., MORTON D. GOLDMAN and STANLEY E. KROSIN,	)	
Defendants.	)	

JUDGMENT

By Order of Court, dated April 11, 1986, the parties in these consolidated cases were realigned so as to show Charter Medical Corporation as plaintiff, Jerome S. Cardin, Jerome J. Coller, M.D., Kenneth E. Hansen, Alexander Grant & Co., Morton D. Goldman, Stanley E. Krosin, Edward Raskin and George Abdow as defendants, and Cardin & Cardin, P.A. and Jerold I. Moskowitz as third-

party defendants. The style of Civil No. H-84-3714 was to remain Jerome S. Cardin, et al vs. Charter Medical Corporation. The claims against defendants Edward Raskin and George Abdow were dismissed in the Pretrial Order dated December 5, 1986. On July 15, 1987, this Court entered an order severing H-85-481 from H-84-3714 and H-85-568.

This consolidated action came to trial before the Court. The issues have been tried and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

1. That the motions for dismissal pursuant to Rule 41(b), F.R.Civ.P., of defendants Jerome S. Cardin, Jerome J. Coller, M.D., Kenneth E. Hansen, Alexander Grant & Co., Morton D. Goldman and Stanley E. Krosin and third-party defendants Cardin & Cardin, P.A. and Jerold I. Moskowitz as realigned, be and the same are hereby granted;

2. That judgment be and the same is hereby entered in favor of defendants Jerome S. Cardin, Jerome J. Coller, M.D., Kenneth E. Hansen, Alexander Grant & Co., Morton D. Goldman and Stanley E. Krosin against plaintiff Charter Medical Corporation, with costs; and

3. That judgment be and the same is hereby entered in favor of third-party defendants Cardin & Cardin, P.A. and Jerold I. Moskowitz against third-party plaintiffs Jerome S. Cardin, Jerome J. Coller, M.D., Kenneth E. Hansen, Alexander Grant & Co., Morton D. Goldman and Stanley E. Krosin, with costs.

DATED: July 15, 1987

/s/ Alexander Harvey, II
Chief United States District Judge

(p. 4001) TRIAL DAY 11 (Vol. 1 of 1)

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

CHARTER MEDICAL CORPORATION Plaintiff v. JEROME S. CARDIN JEROME J. COLLER, M.D. KENNETH E. HANSEN ALEXANDER GRANT & COMPANY MORTON D. GOLDMAN STANLEY E. KROSIN Defendants	Civil No. H-84-3714 Consolidated with Civil No. H-85-568 and Civil No. H-85-481

Baltimore, Maryland
July 15,1987

The above-entitled matter was continued on for trial before the Honorable Alexander Harvey, II, at 10:00 a.m.

(p. 4002) APPEARANCES

On Behalf of Charter Medical Corporation:
H. Lamar Mixson, Esquire
William A. Hylton, Jr., Esquire
Edward B. Krugman, Esquire
John Floyd, Esquire

On Behalf of Cardin, Coller and Hansen:
J. Alan Galbraith, Esquire

On Behalf of Alexander Grant & Co.,
S. Krosin and M. Goldman:
Howard G. Goldberg, Esquire
Deborah K. Sobieski, Esquire

On Behalf of Cardin & Cardin, P.A.:
Lloyd J. Snow, Esquire
Paul F. Newhouse, Esquire

On Behalf of Jerald Moskowitz:
Philip M. Andrews, Esquire

(p. 4003) PROCEEDINGS OF JULY 15, 1987

ORAL OPINION

THE COURT: As realigned, the plaintiff in this civil action is Charter Medical Corporation (hereinafter "Charter"). There are various defendants and third-party defendants. One group of defendants consists of Jerome S. Cardin, Jerome J. Coller and Kenneth E. Hansen, each of whom was an officer of and director of Psych Systems, Inc. (hereinafter "PSI") at the time of the matters in suit. Defendants Cardin, Coller and Hansen will be referred to herein as "CCH". Other defendants are Alexander Grant & Company (hereinafter "Grant"), an accounting firm, and two of its partners, Stanley E. Krosin and Morton D. Goldman. Defendants CCH have asserted third-party claims against Jerald Moskowitz and also against Goldman and Krosin. Grant, in turn, has asserted a third-party claim against Cardin & Cardin, P.A., a law firm and also against Moskowitz.

Charter is a publicly held corporation which is the owner and operator of a number of hospitals located

throughout the United States and abroad. Many of these hospitals are devoted to the rendering of psychiatric care. PSI was at the time of the matters in suit a publicly held Maryland corporation which produced and sold computerized psychiatric testing systems throughout the United States, including computer hardware and software. Grant is a national accounting (p. 4004) firm which served as the independent certified public accountant for PSI for a part of the times involved here..

Commencing in December of 1983 until early June of 1984, there were various discussions between representatives of Charter and representatives of PSI concerning the possibility of Charter's acquisition of PSI. Grant had been engaged to audit PSI's financial statement and had on February 8, 1984, certified PSI's statement for the fiscal year ending November 30, 1983. This statement, an unaudited statement for the quarter ending February 29, 1984, and PSI's Annual 10-K and Quarterly 10-Q forms, were reviewed by Charter in the course of discussions relating to its possible acquisition of PSI.

Initial discussions had comtemplated [sic] a merger, but following a meeting in Atlanta on June 7 and June 8, 1984, the acquisition deal was suddenly converted into a proposed purchase by Charter of certain stock of PSI from CCH. On June 8, 1984, a Stock Purchase Agreement between Charter and defendants CCH was executed. Under that Agreement, Charter purchased 371,919 shares of PSI's common stock from these individuals at a price of $3.50 per share. This represented some 25 percent of PSI's common stock.

It was further agreed that a tender offer would be made at a later date whereby Charter would seek to ac-

quire the remainder of PSI's stock at $5.00 per share. Settlement between Charter and CCH was held in Baltimore on June 11, 1984, (p. 4005) and CCH were then paid $1,301,000 for their stock. Charter had agreed to pay an additional $1.50 per share to these defendants if the proposed acquisition of the remainder of the stock was consummated.

Also, as a part of the Agreement, Charter had five of its representatives placed on PSI's seven-member board so that after the Stock Purchase Agreement was executed and after the closing, Charter controlled PSI's operations.

During the several months after the stock acquisition deal, Charter became aware of information which it believed showed that the financial statements of PSI were false and misleading. Accordingly, Charter decided that it would not attempt to acquire the remaining shares of PSI at $5.00 a share, and on September 5, 1984, it notified defendants CCH that it was rescinding the Stock Purchase Agreement. However, Charter was still interested in acquiring the rest of the PSI stock, and a public announcement was made of a tender offer for the remaining shares of PSI at $1.50 per share. That offer was eventually withdrawn in early October of 1984.

On October 24, 1984, PSI filed Chapter 11 bankruptcy proceedings in this Court. Thereafter, a number of suits were filed in this Court by the parties to this litigation and by others. Subsequently three of these suits involving the parties previously mentioned were consolidated, and the parties were realigned in the manner described.

(p. 4006) Charter claims that defendants CCH entered into a fraudulent scheme to falsely inflate the sales and

earnings of PSI and that they thereby breached the Stock Purchase Agreement. They further contend that defendant Grant and its partners performed an inadequate and fraudulent audit examination of the books and records of PSI and that PSI's financial statements were known to be materially false and misleading. Substantial damages are sought by Charter in this case from each of the defendants named.

Various theories of recovery are asserted against defendants CCH, including:

(1) Breach of contract.

(2) Violations of Federal Securities laws, including:

(a.) Section 12(2) of the 1933 Securities Act,

(b.) Section 18(a) of the 1934 Securities and Exchange Act, and

(c.) Section 10(b) and Rule 10(b)(5) of the 1934 Act.

(3) Violations of the Anti-fraud Provisions of Georgia Securities Law, and

(4) Common law fraud.

Plaintiff Charter seeks recoveries against Grant, Krosin and Goldman under theories of:

(1) Negligence;

(2) Violations of Federal Securities laws, including (p. 4007) Section 18(a) of the 1934 Act and Section 10(b) and Rule 10(b)(5) of the 1934 Act;

(3) Violations of the Anti-fraud Provisions of Georgia Securities law;

(4) Common law fraud; and

(5) Breach of the contract between Charter and CCH, and also breach of a later contract to provide audit services after Charter had purchased the PSI stock. Various theories of contribution and indemnification are asserted by the defendants against the third-party defendants named in this consolidated action.

Following extensive discovery by the parties, a Pretrial Order was entered by the Court. The case then came on for trial before the Court, sitting without a jury. Over a period of some two weeks, various witnesses were called to testify by the plaintiff, and numerous exhibits were offered in evidence by both plaintiff and defendants and were admitted in evidence by the Court.

After plaintiff had rested its case, each of the defendants moved, pursuant to Rule 41(b) of the Federal Rules of Civil Procedure, for an involuntary dismissal. In view of the substantial questions raised, full argument was heard yesterday. Extensive briefs had previously been filed by the parties, both before and during the trial of the case, and the parties there discussed at some length the authorities (p. 4008) applicable to the claims and defenses which have been asserted. Last evening, this Court had an opportunity to further study the briefs; the numerous exhibits; the Court's trial notes; and since there was daily copy in this case, portions of the transcripts.

At the outset, it should be noted that the Court is here dealing with a motion filed under Rule 41(b) of the Federal Rules of Civil Procedure. In a non-jury case, such is the appropriate motion at the close of the plaintiff's case.

Rule 41(b) provides in part as follows:

> "In an action tried by the court without a jury the court as trier of the facts may then determine them and render judgment against the plaintiff or may decline to render any judgment until the close of all the evidence. If the court renders judgment on the merits against the plaintiff, the court shall make findings as provided in Rule 52(a) . . ."

Although a motion for an involuntary dismissal in a non-jury case is somewhat analogous to a motion for a directed verdict, the standard to be applied by the Court in passing on such a motion is significantly different. *See* Wright & Miller *Federal Practice and Procedures:* Civil Section 2529. It is well established that in a case tried without a jury, the trial court is not required to consider the evidence in the light most favorable to the plaintiff in determining whether to grant (p. 4009) a motion to dismiss under Rule 41(b) at the completion of the plaintiff's case, *Woods v. North American Rockwell Corp.*, 480 F.2d 644 (10th Cir. 1973); *Emerson Electric Co. v. Farmer*, 427 F.2d 1082, 1086 (5th Cir. 1970). Rather, the Court should "weigh the evidence, resolve any conflicts in it, and decide for itself where the preponderance lies." *Bertolino v. Italian Line*, 414 F.Supp. 279, 284 (S.D.N.Y. 1976), citing Wright & Miller, *supra*, Section 2371 at page 225. Thus, the Court has the right to use its full judgment on the weight and credibility of the plaintiff's evidence without being required to make inferences in plaintiff's favor. *Emerson Electric Co. v. Farmer, supra.*

Pursuant to the requirements of Rule 41(b), this Court's findings of fact and conclusions of law under Rule 52(a), are included in this oral opinion, whether or not expressly so characterized. Some of the testimony presented was sharply conflicting. In making its findings, the Court has given due regard to the credibility of the witnesses and the weight to be accorded the testimony of each witness.

For the reasons to be stated, this Court has concluded that the motions for dismissal of all defendants, filed under Rule 41(b), must be granted. Judgment will therefore be entered in favor of all defendants, with costs. Judgment will also be entered in favor of the third-party defendants, with costs.

(p. 4010) Essentially, what happened here was that Charter entered into an extremely ill-advised business venture. Indeed, it is difficult on this record for the Court to understand how any responsible corporate executive, knowing what had been disclosed to Charter by early June of 1984, could have so quickly decided (indeed, the decision for the purchase of stock was reached within a period of two days) to purchase a 25 percent interest in PSI, an obviously failing company.

Once having made such an unsound decision, Charter has by these suits attempted to extricate itself by suing the selling stockholders and the accountants, claiming fraud, misrepresentation, violations of securities laws, breach of contract and negligence. But the evidence shows that Charter was so anxious to go through with this deal that any omissions or misrepresentations of financial facts were not material to its decision to purchase

this stock. Moreover, Charter did not rely on the historical financial facts, namely the alleged misstatements or omissions in deciding to consummate this transaction.

If considered in terms of proximate causation, what CCH and Grant did or said was not the cause of Charter's loss. Finally, the facts here show no breach of contract. What Charter got was what it bargained for, namely control of a rapidly dying corporate entity, which was on the verge of bankruptcy, which was not capable of resuscitation even with (p. 4011) large infusions of capital, and which some four months later, did in fact file for bankruptcy.

The weakness of plaintiff's case is emphasized by the number of legal theories advanced by plaintiff in an effort to discover some legal pigeonhole which might permit a recovery. Plaintiff has asserted claims of fraud, negligence and breach of contract, as well as claims under various state and federal statutes, including five separate claims of violations of Federal Securities laws. But when the facts are considered under each of the legal theories advanced, they permit no recovery by plaintiff from any of the defendants in this case under any theory advanced.

The essential facts supporting the Court's conclusions on the various issues presented are as follows: PSI's audited financial statement for the fiscal year ending November 30, 1983 showed an operating loss of $1.2 million. Losses for the first quarter of 1984 on an annualized basis were even in excess of this figure. Some $587,000 of losses were sustained in the first quarter of 1984 which, on a annualized basis, would result in a loss of $2.35 million, almost double the 1983 loss. But this was not all. The Com-

pany's position continued to deteriorate in the months of March, April and May. All of this and more was known by Charter on June 8, 1984.

The essential thrust of plaintiff's claims against the CCH defendants in this suit is that these stockholders of PSI (p. 4012) knowingly submitted false financial information so that Charter would be persuaded to purchase their stock. The facts simply do not support any such conclusion. It was Charter which instituted and pursued the discussions relating to the acquisition. The principal figure for Charter in the negotiations was Robert Porter, who was a vice-president in charge of development of other businesses for Charter. He had many dealings with Moskowitz, PSI's President at the time.

After meeting with Moskowitz in New York in May (and incidentally learning of PSI's further deteriorating financial position) Porter became anxious about the deal and called Cardin in early June, pointing out to him that he had not heard from Cardin since May 17. A meeting was arranged the very next day, June 7, 1984, in Atlanta. It was on that occasion that the Charter representatives were advised for the first time and to their surprise that a merger was out, and for the first time a stock purchase was proposed. Charter was so enamored with the prospects of acquiring PSI that it readily agreed to the new arrangement. The stock purchase deal was put together in the very short period of two days after it was first suggested. Settlement was held only three days later. This hardly gave Charter time to check out or weigh certain crucial additional facts which had been disclosed during the meetings of June 7 and June 8.

In particular, Charter's representatives were told in (p. 4013) Atlanta on June 7 and 8 that the financial condition of PSI had deteriorated even further since the disastrous fiscal year 1983 statement and the even worse first quarter 1984 statement. They were told that bankruptcy was imminent. They knew that, to keep PSI alive, Charter would have to advance substantial funds to PSI during the first three months after the stock deal was closed. They knew that PSI had little or no collateral for any such advances from Charter, and they knew that institutional lenders had refused during the spring of 1984 to loan additional funds to PSI.

So precarious was PSI's position that the normal time for settlement was advanced. Even Chesney, Charter's Chief Financial Officer, thought that this early closing date was unusual. Settlement was held only three days after the Stock Purchase Agreement was executed on June 8, 1984 because Cardin had advised Charter's representatives that if settlement was put off for 30 to 60 days, there would be no PSI around at the time of settlement for Charter to acquire.

Charter was acquiring an insolvent company and knew it. Nevertheless, Porter and Stevenson felt that PSI's business would be synergistic with that of Charter and that there would be a bright future for Charter's operations based on a changed concept for doing business. Fearing that a competitor would buy PSI if Charter did not, Porter and Stevenson acted hastily and without further investigation, (p. 4014) knowing that PSI was nearly bankrupt.

The information furnished to Charter's representatives on June 7 and June 8 refute the existence of any

scheme to defraud. Indeed, why would Cardin tell Charter's people that PSI was on the verge of bankruptcy, certainly an extremely negative fact, if he wished to persuade them by various misrepresentations and omissions to purchase his stock?

Porter was so desperately anxious to make the deal that he chose to overlook other adverse factors. The MMPI license represented 60 percent of PSI's earnings from software. Of course, total earnings as of June 1984 were even pointing to a loss of some $2.5 million for the 1984 fiscal year. PSI's principal competitor, National Computer Systems, owned the license, and had stated in writing that the license would not be renewed after it expired in 1986.

Porter had told Stevenson, his superior, that Cardin had guaranteed that the extension would be forthcoming. This was erroneous information as no such guarantee had been made. Anyone acquainted with the facts should have realized that there was an extremely serious risk that the license would not be extended.

Porter, of course, hoped that everything would work out and was willing to assume this very substantial disk, which as it turned out was an extremely ill-advised decision on his part. What this indicates, however, is that whatever the risks (p. 4015) and adverse implications, Porter and his superiors were prepared to go through with the deal. Quite obviously, the alleged misstatements and omissions in the financial reports were hardly material to Charter's ultimate decision, and the historical financial facts were not relied upon by Charter in deciding to enter into the Stock Purchase Agreement. The

Court would note that Porter had previously had credibility problems with his superiors at Charter, and when the PSI deal foundered, he was later fired.

The fact that Charter did not rely on the historical financial data of PSI is underscored by the testimony of Ray Stevenson, Charter's President at the time of the matters in suit. He testified:

> "nobody would buy that business on the basis of the financial statement as it was . . . It was obviously hurting and limping and a hair away from financial trouble."

It was Stevenson's view that renewal of the MMPI license was absolutely essential to the acquisition. As noted, it was quite doubtful at this time that the extension would be forthcoming.

The question then arises: Why did Charter purchase this stock? The answer is likewise supplied by Stevenson who testified that Charter was buying the business mainly because of where Charter thought it could take it.

(p. 4016) Porter's testimony likewise makes it clear that Charter was buying a concept which was thought to have great future potential. But this involved a restructuring and a change in the operation of PSI's business, particularly in the marketing area.

Porter was so enamored with the changed concept that he even did not heed the views of other Charter personnel. Porter sent Jerold Cooper, a Charter auditor, to PSI's offices in Baltimore in April of 1984 so that projections could be secured for earnings and expenses for the three-year period from 1984 to 1987. These revenue pro-

jections were not based on the 1983 PSI financial statement. The original projections did not even meet the criteria set forth in Charter's investment parameter worksheets for acquisitions. However, the projections were reworked, and they finally did pass.

It is significant that Porter was told by Andy Galloway, another Charter employee who had studied the financial facts, that although there was a potential for the prospective marketing of PSI's systems in the future under the new concept, no specific market research had been completed to determine if such a market existed.

Galloway further stated that without detailed market research, there was no basis for including these suggested operating results in a *pro forma* statement. There was even a notation in Galloway's memorandum of May 10, 1984 that PSI (p. 4017) would be bankrupt by the time any research was completed. Porter ignored this comment also and even testified at the trial that it must have been placed there "in jest."

In this report, Galloway stated that PSI's 1984 losses would exceed those of 1983, that PSI's operating losses resulted from bad decisions of management and that PSI was a poorly managed company. In spite of knowing all of this, Charter went forward with the deal.

Another significant fact here is that in the Spring of 1984, a dramatic change was occurring insofar as PSI's market was concerned. The change to micro computers was driving down the price of computer hardware. Charter and PSI were therefore faced with a whole new ballgame, and Charter's projections were accordingly based

on leasing rather than selling. But this had never been done before. Thus, the problem with such projections was that there were no concrete market facts which would give validity to the assumptions made. Nevertheless, Charter plunged heedlessly ahead, acting on the basis of future assumptions rather than on any historical financial facts contained in the 1983 financial statement.

Plaintiff relies heavily on the fact that representatives of Charter were never told that Grant had recommended that Moskowitz should be fired. When considered in the context of other evidence in the case, this was not a material omission nor one which Charter would have relied on. (p. 4018) The evidence discloses that after considering Grant's recommendation, PSI decided to reduce Moskowitz's authority over financial matters, keep him on temporarily because of his abilities in sales and marketing, and eventually replace him. This was a reasonable decision under all the circumstances and was accepted as such by Grant. Certainly, there is no evidence that CCH completely ignored Grant's recommendations. Indeed, Wilowatyj was fired as Grant suggested.

Interestingly enough, a very similar decision as to Moskowitz was reached later by Porter himself. On August 2, 1984, Porter had been advised of and became very upset over revelations concerning Moskowitz's attempts to inflate sales. Not only was Moskowitz not fired (and indeed he was kept on as President of PSI and a Director even after the bankruptcy proceedings were commenced in October) but Porter even went with Moskowitz to a convention in late August, and Porter was very proud of the fact that he and Moskowitz walked away with 25 to 30 new

orders. In other words, plaintiff Charter, like defendants CCH, did not fire Moskowitz even after learning of these irregularities, but rather kept him on because of Moskowitz's perceived abilities in sales and marketing.

In any event, Porter know that PSI had no financial department, and Porter had been advised by Galloway that PSI was a poorly managed company and that its operating losses had resulted from bad decisions of management. Under these (p. 4019) circumstances, the fact that neither Grant nor Cardin told Charter of Grant's recommendation to fire Moskowitz could hardly have been a material omission in connection with Charter's decision to purchase this stock.

With reference to the issue of inflated sales appearing in PSI's 1983 statement, this Court concludes that it was entirely reasonable for defendant Grant to conclude, on the basis of information available in January and February of 1984, that the KAMS transactions were properly recorded as completed sales. Moreover, it was reasonable for defendants CCH to rely on Grant's audit. The evidence available at that time indicated that there was in fact a valid power of attorney given by Ashton to Richards.

Ashton met with Moskowitz and Wilowatyj on January 23, 1984, and after he was shown certain documents, he was persuaded that his initial response was incorrect. His subsequent response confirmed some $383,900 worth of invoices to KAMS. The evidence does not support the appropriateness of many of Charter's other proposed adjustments to the 1983 statement. With the benefit of hindsight, undoubtedly some of the sales should not have been

recorded as such. However, PSI's 1983 statement would not have been materially affected. Even if all of plaintiff's adjustments were accepted, they would not, in any event, for the reasons previously stated, be material to the investment decision made; nor would they have (p. 4020) been relied upon by Charter.

The Court will now discuss the various legal theories advanced by the plaintiff in light of these findings of fact.

I

Breach of Contract—The Stock Purchase Agreement

There was no breach of the Stock Purchase Agreement by defendants CCH or of the accounting contract by Grant under a third-party beneficiary theory. In purchasing a 25 percent interest in the common stock of PSI and in securing control of PSI, Charter received exactly what it bargained for, namely stock of a corporation in serious financial trouble, on the verge of bankruptcy and with dim prospects of any future success.

Plaintiff contends that defendants CCH did not meet their obligations under Paragraph 5 of the Stock Purchase Agreement, with reference to representations and warranties of the shareholders. This Court would disagree. That clause excepts from the representations and warranties as set forth information "otherwise disclosed by shareholders."

The crucial facts pertaining to PSI's imminent bankruptcy and bleak future prospects without an infusion of a large amount of capital from Charter were indeed disclosed to Charter before the Agreement was signed. There is no merit to plaintiff's argument that this clause means

otherwise disclosed by documents. The language used simply does not say that.

(p. 4021) II

Claimed Violations of Federal Securities Laws

To succeed under Section 10b of the 1934 Act and Rule 10b-5, plaintiff must prove scienter—that is, that defendants acted with intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hockfelder,* 425 U.S. 185 (1976). The evidence presented by plaintiff fails to prove any such intent on the part of Cardin or Coller or Hansen.

One who would seek to deceive a prospective purchaser of stock would hardly, as did Cardin, reveal that the corporation in question was on the verge of bankruptcy and that unless the closing were held promptly, there would be no corporation in existence within 30 to 60 days.

The most that plaintiff can prove is that Wilowatyj and Moskowitz devised a scheme to inflate sales, but as indicated, the amount of the inflated sales were nowhere near the figure claimed by plaintiff. Keith Ashton described a scheme of this sort quite well. In suggesting that Wilowatyj and Moskowitz were taking steps at the end of year to make the financials look good, Ashton stated that "we all play the game." The game, of course, was to make the financial figures look good for the Board.

Certainly, as Grant's audit disclosed, there were a number of sales improperly recorded as such. Indeed, as a result of Grant's audit, the 1983 statement was changed from (p. 4022) showing a small profit to showing a loss of $1.2 million. There is nothing to indicate that defendants CCH had any knowledge that any of the sales which were

approved by Grant were in fact fraudulent sales. Indeed, Cardin specifically told Krosin that he wanted Grant to "get it right." Krosin found Cardin to be forthright in his concerns and in his instruction that he wanted the financial figures to be accurate. Moreover, there is no indication that Cardin or Coller or Hansen attempted in any way to hinder Grant's investigation of all the financial facts. No evidence has therefore been presented of any intent to deceive or other fraud on the part of these defendants, nor is there credible evidence of any intent on the part of these defendants to conceal any representations or omissions.

All of plaintiff's claims asserted under Federal Securities law also involve issues of materiality. An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in his decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information available. *Id.* Determinations as to materiality are normally left to the trier of fact. *Lockspeiser v. Western Maryland Co.*, 768 F.2d 558, 561 (4th (p. 4023) Cir. (1985).

When these principles are applied to the facts of this case, this Court concludes that the alleged misrepresentations and omissions were not material to Charter's decision to purchase this stock from CCH, whether the issue is considered under Section 10b and Rule 10b-5 of the 1934 Act, under Section 12(2) of the 1933 Act, or under Section 18(a) of the 1934 Act. No substantial likelihood has been shown that a purchaser in Charter's shoes, desiring a synergistic

result based on *pro forma* future projections, would have viewed disclosure of the alleged misrepresentations and omissions as having significantly altered the total mix of information available. Nor is there evidence of concealment. Far from concealing fraud as argued by plaintiff, Cardin at the meetings held on June 7 and June 8 even supplied further adverse financial information, bringing up to date financial data previously disclosed that PSI was in a precarious financial position.

The facts similarly show that plaintiff did not rely on the alleged misrepresentations and omissions. To recover for common law fraud, the representation or omission must play a substantial part in affecting the decision. *See* Restatement of Torts, Second, Section 546. A similar standard applies in a Rule 10b-5 case. *See List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.) *cert. denied*, 382 U.S. 811 (1965).

Not only has plaintiff failed to prove the necessary (p. 4024) element of reliance under Maryland law, under Georgia law, or under Federal law, but the facts as found by this Court and previously discussed actually disclose that there was no reliance by plaintiff on the historical financial facts at issue.

III

Claimed Violations of Georgia Securities Law

Plaintiff has also sought a recovery under the Georgia Securities Act, O.C.G.A. Section 10-5-12(a) and Section 10-5-14(a). The Court's discussion of plaintiff's claims asserted under Federal Securities Law is likewise applicable to plaintiff's claims asserted under Georgia Securities Law. For the reasons stated by the Court, in dis-

cussing plaintiff's claims asserted under Federal Law, plaintiff is not entitled to a recovery under the Georgia Securities Act.

IV

The Claims Against Defendants Grant, Krosin and Goldman

The issues raised by plaintiff's claims against Grant and two of its partners can be resolved in short order. This Court finds from the evidence that Grant's audit of the 1983 financial statements was done in an appropriate manner and in conformity with generally accepted auditing standards. It was therefore appropriate for Grant to give an unqualified opinion. In this connection, the Court will credit the testimony of defendant Stanley Krosin, which was supported by his workpapers (p. 40025) and by other evidence in the case.

When Grant personnel learned of certain problems in connection with the recording of sales in PSI's statement for fiscal 1983, Grant went to great lengths to check the validity of numerous transactions. As noted, as a result of Grant's reversal of these transactions, the audited statement showed a loss of $1.2 million as opposed to the original small profit. Krosin even made the conservative suggestion that another $100,000 be added to the reserve allowance for doubtful accounts. Coller and Cardin readily concurred with this suggestion, as they had with other suggested accounting changes recommended by Grant.

Little weight will be accorded the opinions given by Bryon Finn and Alan Certain in their testimony. Finn's credentials as an experienced accountant hardly came close to those of Krosin. Certain's opinions were subjective,

were based on inferences derived from facts not proven, and in many respects amounted to no more than 20-20 hindsight conclusions based on facts that were not and could not have been known by Grant. I found Certain to be glib and unnecessarily expansive in his views. Where his opinions conflicted with those of Krosin, the Court will credit Krosin's views over those of Certain.

Interestingly enough, Finn and Certain disagreed as to an important accounting principle insofar as this case is (p. 4026)concerned—namely, when during the course of a shipment, a sale can be recorded on the seller's books. Incidentally, in this connection, the evidence does not support plaintiff's contention that Glenair acted as a warehousing firm for PSI. Glenair was a legitimate freight-forwarder, and shipments covered by Systems Agreements could properly be recorded as sales when received by Glenair.

The credible evidence here further indicates that Grant acted in good faith and had no knowledge of the falsity of the alleged misrepresentations and omissions.

For all these reasons, plaintiff is not entitled to a recovery of damages from Grant, Krosin or Goldman because of alleged misrepresentations or omissions in the 1983 statement.

V

Common Law Fraud

Much of what has been said likewise applies to plaintiff's claims asserted against all defendants based on a theory of common law fraud. Whether Maryland law or Georgia law is applied, plaintiff's proof is lacking in several essential respects.

Plaintiff has not met its burden of proving an intent to deceive on the part of any of the defendants. Moreover, there is no proof of reliance by Charter on the alleged misstatements and omissions. Finally, the evidence does not indicate that the defendants had knowledge of the falsity of (p. 4027) the alleged misstatements or omissions. Plaintiff's fraud claims must therefore fail.

VI

Negligence

Similarly, plaintiff cannot succeed against defendants Grant, Krosin or Goldman under a theory of negligence. As disclosed by the testimony of Krosin, the accountants were not negligent or reckless in the performance of the services they rendered PSI. Furthermore, any acts or omissions on the part of the accountants were not the proximate cause of the losses sustained by plaintiff Charter because of its purchase of this stock.

VII

Breach of Contract Claim Against the Accountants

Plaintiff has also asserted a separate breach of contract claim against defendant Grant. It is contended that pursuant to a contract between Grant and Charter which was not performed, Charter is entitled to recover damages.

The evidence, however, discloses that Grant was employed by PSI and not by Charter. Since Charter was not a party to this Agreement, it is not entitled to any recovery from Grant. Indeed, Grant has repaid in the PSI bankruptcy proceedings some $57,600 pursuant to a settlement of that account.

(p. 4028) VIII

Ratification

Finally, even if there were a breach of contract, plaintiff Charter would not be entitled to a recovery from CCH or a right to rescind the Stock Purchase Agreement because, by its later actions, it ratified its previous intention to go forward with acquiring the PSI stock.

As early as July 17, 1984, Porter had knowledge of financial facts which some six weeks later caused Charter to seek to rescind the Agreement. Further facts were ascertained in later weeks, in particular on August 2 when Porter flew to Minneapolis wth Moskowitz. Nevertheless, even after hearing that the MMPI license would not be extended, Charter went ahead with its $1.50 tender offer in late August and early September.

Charter still felt that the concept was synergistic, and even with all the information that had come to light in July and August of 1984, it was still prepared to acquire this rapidly failing company. What in fact precipitated the notice of rescision was the letter indicating that the MMPI license would not be extended. Nevertheless, even knowing this, Charter still made the $1.50 tender offer. These facts amount to a ratification of the earlier Agreement which would not, even had there been a breach, permit plaintiff to recover damages or rescind.

For all these reasons, the motion to dismiss of (p. 4029) defendant CCH filed under 41(b) will be granted. The motion to dismiss of defendants Grant, Goldman and Krosin will likewise be granted. Judgment will accordingly be entered in favor of these defendants, with costs.

Since defendants have prevailed, the motions to dismiss of the third-party defendant Moskowitz and of third-party defendant Cardin & Cardin will likewise be granted. Judgment will accordingly also be entered in favor of these third-party defendants, with costs.

Let me thank counsel for your consideration throughout this case.

Mr. Galbraith: Your Honor, I do have one further matter. In the pretrial statement, pursuant to the Stock Purchase Agreement, we have a claim for attorneys' fees. How would you want to handle that?

The Court: That will be denied under these facts.

Mr. Galbraith: Okay.

The Court: You didn't put that in as a counterclaim. If you want to file a request for attorneys' fees under Local Rule 23A, that is something else. But your claim is essentially a counterclaim, not preserved as such in the Pretrial Order and not discussed yesterday. As far as I am concerned, when these Orders are entered, that is going to close everything out. Your claim will not be allowed.

Mr. Galbraith: Fine.

(p. 4030) The Court: We will stand adjourned.

Counsel: Thank you, Your Honor.

(The proceedings were then adjourned.)

UNPUBLISHED

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 87-1157

JEROME S. CARDIN; JEROME J. COLLER, M.D.; KENNETH E. HANSEN

Plaintiffs - Appellees

versus

CHARTER MEDICAL CORPORATION, a Delaware Corporation

Defendant - Appellant

v.

MORTON D. GOLDMAN; STANLEY E. KROSIN; GEORGE ABDOW; GERALD I. MOSKOWITZ

Third-Party Defendants

Appeal from the United States District Court for the District of Maryland, at Baltimore. Alexander Harvey II, Chief District Judge. (CA-84-3714-H)

Argued: March 9, 1988 Decided June 17, 1988

Before WINTER, Chief Judge, WIDENER, Circuit Judge, and McMILLAN, United States District Judge for the Western District of North Carolina, sitting by designation.

Edward B. Krugman (H. Lamar Mixson; Bondurant, Mixson & Elmore; William A. Hylton; Hylton & Gonzales on brief) for Appellant; John Alan Galbraith (Williams & Connolly on brief) for Appellees.

PER CURIAM:

As realigned by the district court, Charter Medical Corporation (Charter) sued Jerome S. Cardin, Jerome J. Coller and Kenneth E. Hansen, the principal stockholders of Psych Systems, Inc. (PSI), alleging violations by the defendants of the Georgia Securities Act and the federal securities laws, common law fraud and breach of contract in Charter's purchase of defendants' shares constituting 25% of the total stock of PSI.* The district court after trying the case non-jury for two weeks granted a motion at the close of Charter's evidence for defendants pursuant to Rule 41(b), F.R. Civ. P. The district court rendered a thorough oral opinion and made detailed findings of fact.

Charter appeals, and we affirm.

I.

Charter is the owner and operator of a number of hospitals throughout the United States and abroad, approximately 30 of which are devoted primarily to rendering psychiatric care. This case is unique as an example of

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* In the proceedings in the district court, Charter also sued Alexander Grant & Co. (AG & Co.), PSI's accounting firm, alleging that if defendants were liable to Charter due to deficiencies in the audited financial statements, then AG & Co. was liable to defendants. The district court gave judgment to AG & Co. and Charter has not appealed. We therefore have no occasion to consider this aspect of the case.

the subsequently established ill-advised persistence of Charter, to obtain control, if not ownership, of PSI, which produced and sold computerized psychiatric testing systems, notwithstanding that it was fully advised that PSI was losing substantial sums of money and that it was on the verge of the bankruptcy which shortly ensued. Undoubtedly Charter believed that if it obtained control, its management expertise and large infusions of cash that it could provide, could render PSI a profitable enterprise. Unfortunately, Charter's faith in its own abilities was sadly misplaced.

Initially Charter sought to merge with PSI, but in June 1984 its acquisition effort took the form of a stock purchase agreement whereby its purchased 25% of PSI's stock from defendants at a price of $3.50 per share. It was further agreed that Charter would make a tender offer at a later date to acquire all of PSI's remaining stock at $5.00 per share. Settlement of the purchase from defendants was made within three days after agreement was reached, and Charter further agreed to pay defendants an additional $1.50 per share for their stock if the proposed acquisition of the remainder of the stock was consummated. Pursuant to the stock purchase agreement, Charter obtained immediate control of PSI's board of directors.

Prior to the June 1984 stock purchase and during the merger negotiations, Charter had obtained audited financial statements of PSI's operations. They showed that for the fiscal year ending November 30, 1983, PSI had an operating loss of $1.2 million and for the first quarter of 1984, losses of $587,000, which, if annualized, would indicate a loss of $2.35 million for fiscal 1984. Immediately

prior to the execution of the stock purchase agreement and the accelerated settlement thereunder, Charter was told that PSI's financial condition had worsened since the audited financial statements and that bankruptcy was imminent. The district court found that Charter was in fact motivated to enter into the stock purchase agreement by news of PSI's imminent bankruptcy. The stock agreement was negotiated and executed within two days, and settlement occurred only three days later. The district court found that Charter knew that to keep PSI alive, it would have to advance substantial funds to PSI immediately, but that it decided to proceed with the agreement based on "*pro forma* future projections." Charter's hopes rested largely on a license from which 60% of PSI's earnings were derived, despite the fact that Charter knew that PSI had been told the license would expire and was unlikely to be renewed. The district court found that Charter Vice President Robert Porter was "so desperately anxious to make the deal" that he "chose to overlook" the fact that a license owned by one of its competitors would soon expire. We may infer that Porter somehow hoped the license could be extended. The district court found that Porter told his superior at Charter that an extension would be forthcoming despite the absence of such a guarantee.

By July 1984, Charter became aware that certain sales figures reflected in the financial statements for fiscal 1983 and the first quarter of fiscal 1984 were inflated. PSI and its principals had been alerted to this possibility earlier by its accountants, PSI had instructed its accountants "to get it right," and the accountants had disallowed some sales. If the remaining inflation of sales not disallowed by AG &

Co. were eliminated from the financial statements, obviously PSI had experienced even more dismal operating results in fiscal 1983 and the first quarter of fiscal 1984.

Notwithstanding this knowledge, Charter persisted in its efforts to make PSI an operating success after the June 1984 stock purchase agreement. It continued to supply working capital and other funds. In the interim Charter learned that PSI's software license would definitely not be renewed. Nonetheless, in late August and early September 1984, Charter proceeded with a tender offer to acquire PSI's publicly owned stock at $1.50 per share. The offer was subsequently withdrawn in October 1984.

On September 5, 1984, Charter notified defendants that it was rescinding the stock purchase agreement and would seek damages for breach of contract and fraud. The district court found that Charter's rescission was precipitated by notice that the software license would not be renewed. This suit was filed October 5, 1984, and PSI filed Chapter 11 bankruptcy proceedings on October 24, 1984.

II.

Charter's suit alleged causes of action arising under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), § 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r and Rule 10b-5 promulgated thereunder, 15 C.F.R. § 240.10b-5, the Georgia Securities Act, common law fraud and breach of contract. With respect to each, the district court made extensive findings of fact and stated conclusions of law.

Most importantly the district court found that any omissions or misrepresentations of financial facts were

not material to Charter's decision to purchase PSI's stock, that Charter in its purchase decision did not rely on historical financial facts, that there was no proximate causation between what defendants and AG & Co. did or said and Charter's loss, and that Charter obtained what it bargained for in the stock purchase agreement. Specifically it found that even if some of the sales had been reversed, the financial statements would not have been materially affected, and, further, that even if adjustments claimed by Charter had been made, they would not have been material to Charter's investment decision and would not have been relied on by Charter.

The district court found that Charter was fully informed of PSI's disastrous financial state as of June, 1984, so that there could be no proper basis on which to find a breach of contract. It also found that defendants had no scienter on which to support a claim of breach of securities laws. The finding that the alleged misrepresentations and omissions were not material and that Charter did not in fact rely on historical financial information were repeated. Charter's claim of common law fraud was rejected because there was no proof on the part of any defendant of an intent to deceive and there was no proof on the part of Charter of reliance. Finally the district court found that Charter had ratified the transaction by its actions following the alleged discovery of misrepresentations and omissions.

Our review of the record and consideration of the arguments, both oral and written, persuades us that the district court's findings of fact are not clearly erroneous and its conclusions of law are correct. Except for supple-

mentation to deal specifically with two arguments vigorously pressed on us, we are altogether satisfied to affirm the district court's judgment on its opinion. Charter Medical Corporation v. Cardin, Civ. No. H-84-3714, D. Md., July 15, 1987 (unreported). We turn then to the arguments pressed on us that Charter proved a cause of action for breach of warranty and a cause of action for violation of § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2).

III.

Both of the alleged causes of action arise from the inclusion of inflated sales figures and the omission of certain liabilities in the financial data furnished Charter prior to settlement of the stock purchase agreement. Charter argues that sales were inflated in the approximate amount of $300,000 and that a $700,000 liability of PSI to a supplier was omitted. While defendants contest the correctness of the figures advanced by Charter, the district court made no finding as to the exact amount of either. We cannot determine the exact total of inflated sales not disallowed by AG & Co. before the stock purchase agreement was executed, but our study of the record indicates that it could range from $117,823 to $297,868. The alleged liability of $700,000 stands on a different footing, however. It was disclosed in some versions of PSI's 1983 financial statement.

We discuss the alleged liability first. It is claimed to be to Oceanic Enterprises, Inc. (OEI), which supplied PSI with computer equipment manufactured by Digital Equipment company. OEI, of course, maintained an inventory of what was needed from time to time, but under the agree-

ment between them, PSI was not obliged to pay OEI until OEI shipped equipment to one of PSI's customers. After Charter bought control of PSI and announced its tender offer of $1.50 per, OEI asked PSI to pay for OEI's inventory which was held for PSI's customers. OEI claimed that PSI had orally agreed to do so. There is no evidence that OEI had even made a previous demand, or that there was such an oral agreement, or that the statute of frauds would not bar the claim. In any event neither Charter's outside counsel nor its accountant took the claim seriously. Indeed, PSI, on March 14, 1985, when it was controlled by Charter advised the SEC that it "was aware of no documentation to support the claim, disputes the claim, and has recorded no obligation for such equipment." We therefore conclude that this item was not an improperly omitted liability and that the most which concerns us is the inflation of sales in the range we have set forth.

We do not think that the alleged inflated sales give Charter a meritorious cause of action. A cause of action under § 12(2) requires proof of "an untrue statement of a material fact or . . . . [the omission] to state a material fact necessary in order to make the statements . . . . not misleading," but the section further provides that seller of securities shall not be liable thereunder if he shows "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . " 15 U.S.C. § 77*l*(2).

Although § 12(2) may be construed to place the burden of proof on the seller to demonstrate lack of knowledge, the district court found that "the evidence does not indicate that the defendants had knowledge of the falsity of the

alleged misstatements or omissions," that "[t]here is nothing to indicate defendants . . . had any knowledge that any of the sales . . . were in fact fraudulent sales," and that defendants had made a reasonable effort to cure the problem and could reasonably believe the problem had been completely solved by AG & Co. We think that these findings are the functional equivalent of that required by § 12(2). These findings are not clearly erroneous. The district court credited testimony that one of defendants told PSI's auditor to "get it right" and it found that none of the defendants attempted in any way to hinder an investigation of all the financial facts, thus demonstrating reasonable care. *See* Sanders v. John Nuveen & Co., 619 F.2d 1222, 1227-28 (7 Cir. 1980), *cert. denied,* 450 U.S. 1005 (1981). We therefore conclude that defendants did not know and should not have known of inflated sales in the audited November 30 sales figures so that Charter has no cause of action therefor [sic] under § 12(2).

We do not think that Charter's breach of warranty claim has any greater merit. While it is true that in the stock purchase agreement, defendants warranted the financial reports as not containing "any untrue material fact or ommitt[ing] any material fact required to be stated therein or necessary to make the statements therein not misleading," the warranty was qualified by the exception of "any document delivered pursuant to or in connection with this Agreement *or otherwise disclosed by Shareholder* [*defendant*] *or their representatives to Charter*" (emphasis added). Even if inflated sales of .1-.3 million abstractly was a material fact, we think that the intelligence that PSI was on the verge of bankruptcy, communicated before set-

tlement under the stock purchase agreement, not only fell within the exception but made those inflated sales that remained uncorrected not material. In regard to the latter, we note that the district court found that what prompted purported recession of the stock purchase agreement was the letter that PSI's license agreement would not be renewed. That finding is not clearly erroneous.

In any event Charter learned that sales may have been inflated on July 17, 1984. It did not rescind then or in a reasonable time thereafter. Instead it continued to receive the benefit of the contract until September 5, 1984 when it learned of the license nonrenewal. Even then it began a public offer to purchase PSI stock thereafter. We think that the district court correctly concluded that even if there had been a breach of warranty, Charter ratified its previous contract by deferring any effort to rescind and by proceeding to acquire PSI's remaining stock.

AFFIRMED.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 87-1157

(Filed July 20, 1988)

Jerome S. Cardin, et al,

Plaintiffs-Appellees,

v.

Charter Medical Corp., etc.,

Defendant-Appellant,

v.

Morton D. Goldman, et al,

Third Party Defendants.

On Petition for Rehearing with Suggestion for Rehearing In Banc

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The appellant's petition for rehearing and suggestion for rehearing in banc were submitted to this Court. As no member of this Court or the panel requested a poll on the suggestion for rehearing in banc, and

As the panel considered the petition for rehearing and is of the opinion that it should be denied.

IT IS ORDERED that the petition for rehearing and suggestion for rehearing in banc are denied.

Entered at the direction of Chief Judge Winter, with the concurrence of Judge Widener and Judge McMillan, United States District Judge sitting by designation.

For the Court
JOHN M. GREACEN
CLERK

March 4, 1984

PLAINTIFF'S EXHIBIT NO. CMC 229

CASE NO. H-84-3714 CONSOLIDATED

IDENTIFICATION: .....

ADMITTED: .....

Rec'd from Jerry Coller

I presented my concerns about Walter Wilowatyj's ability to perform to Moskowitz and to the Board and the Chairman. I urged Moskowitz to get rid of him within just a few weeks after he arrived. Not only was he embarrassing to the company in his meetings with Westergard, American Security Bank, etc. but he made no attempt to set controls for the financial aspect of the company. I expressed my concern to a friend Mr. G. Scheinker of Legg Mason. I went so far as to interview Mr. Stan Katz for the position. I was confronted by Moskowitz as to my interference and then informed by the Board not to interfere in the operations of the company. I continued to urge Walter Wilowatyj's dismissal to the Board, Moskowitz, and expressed my concerns to Dr. Fowler. Shortly before the end of the quarter I was informed by members of the company that sales appeared far short of projections. I informed Moskowitz of my concerns and he assured me sales would reach 2.1 mil.

After the Thanksgiving holidays I was informed the 2.1 mil. number had been met. However, by the first week in Dec. I received information that some systems that had been shipped subsequently were returned. I then informed the Board and Mr. Cardin by note prepared for me by Ms. Dunie upon information supplied by others in the Shipping Dept. We were assured that most of the systems were not

in the 2.1 mil. figure but one was sent back because the room was not ready this month. I also learned that certain systems shipped were not accepted by customers and at BWI and at OEI. I questioned this and assured that these systems were destined for customers and was admonished by Moskowitz for interfering in his operation of the Company by seeking information directly from members of the staff. I was informed by the Board to always seek information through Moskowitz. Especially noted was the request not to talk to (1) Gee about tests available, (2) to Doug about the finances, and to Patrick about technical aspects. As a matter of fact, Patrick did not answer my phone call when it was necessary to obtain information when requested by NCS to explain IBM security. It was later that Doug McGarvey informed me that he was directed by Moskowitz and Walter Wilowatyj not to provide me with information concerning the Company.

I was further told by Renie Dunie and Lee Richards that Moskowitz had told each of them separately that he would be able to pull off that inflated sales report because the auditors were "too dumb to pick it up". I have concerns that knowing all of this keeping Moskowitz in a place of responsibility where he can make decisions or committment that adversely affect the Company subjects me to legal exposure. Yet he has certain successful endeavors with the Company in relation to customer relations—sales in the industrial market that makes his presence critical at this time. Knowing all of this, I think he should stay but needs very careful watching.

It was not until I was asked by Walter Wilowatyj to contact Dr. N. Solomon and request him to send his con-

firmation letter back as a yes rather than a no—I called Dr. Solomon who informed me at first that he and his partners had not agreed as to how much each partner would be responsible for payment for the equipment. I asked him to please settle their problems and sign a new confirmation letter. He called me later to tell me he couldn't sign the letter as he really hadn't bought the system and might not ever. I could not beleve [sic] this and asked him when he had signed a systems agreement and given a deposit. He informed he had signed nothing. I immediately went to his folder and found in fact there was no signed contract. As a matter of fact there was nothing in the folder. When confronted Moskowitz and Wilowatyj told me this and one other case were the only ones like this. I then went to George A the auditor who told me I had "problems". This was a Friday afternoon. George told me he didn't know anything else to tell me and didn't want to worry me over the week-end.

I called George on Monday when he told me the problem was more extensive then I had been told. Moskowitz and Wilowatyj continued to assure me daily that the problems were limited. Each day however, the accountants found more evidence of attempts to cover up the sales problem.

The only decrease in expenses was to eliminate the P.R. I objected to this and conveyed my objections to the Board.

PLAINTIFF'S EXHIBIT NO. CMC 332
CASE NO. H-84-3714 CONSOLIDATED
IDENTIFICATION: ————
ADMITTED: ————

Draft No. 4
RWM/0689n
6/8/84

STOCK PURCHASE AGREEMENT

THIS STOCK PURCHASE AGREEMENT (the "Agreement") is made this 8th day of June, 1984, by and among CHARTER MEDICAL CORPORATION ("Charter"), a Delaware corporation, and the following shareholders of Psych Systems, Inc., a Maryland corporation ("PSI"): JEROME S. CARDIN; JEROME J. COLLER, M.D.; and KENNETH E. HANSEN (referred to herein individually as "Shareholder" and collectively as "Shareholders")

WHEREAS, Charter desires to purchase from Shareholders and Shareholders desire to sell to Charter shares of the $0.01 par value Common Stock of PSI ("PSI Common Stock") listed in Section 1 of this Agreement; and

WHEREAS, Shareholders and Charter desire to make certain other agreements and covenants as contained herein;

NOW, THEREFORE, Charter and Shareholders, in consideration of the mutual promises and covenants contained herein do hereby agree as follows:

1. *Purchase of PSI Common Stock.*

1.1. *Ownership of Shares of PSI by Shareholders.*

Shareholders severally and not jointly represent and warrant to Charter that Shareholders are the record and beneficial owners of shares of PSI Common Stock as follows:

Name	Number of Shares
Jerome S. Cardin	156,304
Jerome J. Coller, M.D.	106,523
Kenneth E. Hansen	109,092
Total	371,919

Shareholders severally and not jointly represent and warrant to Charter that Shareholders own the shares of PSI Common Stock as listed above of record and beneficially free and clear from any claims, pledges, liens or encumbrances whatsoever. Shareholders severally and not jointly represent and warrant to Charter that Shareholders have full power and authority to sell to Charter the above-listed shares pursuant to this Agreement and to transfer to Charter good and marketable title to such shares, upon closing, free and clear of any claim, pledge, lien or encumbrance whatsoever. Shareholders severally and not jointly represent and warrant to Charter that the above-listed shares of PSI Common Stock were duly and validly issued and are fully paid and nonassessable.

1.2. *Purchase of Shares of PSI Common Stock.* On the Closing Date, Charter shall purchase from Shareholders and Shareholders shall sell to Charter the 371,919 shares of PSI Common Stock listed in Section 1.1. The Closing of the purchase shall occur at the offices of the transfer agent and registrar for the Common Stock of PSI, Union Trust Company of Maryland, Baltimore, Maryland, or such other place as the parties may agree. Shareholders, at the Closing, shall deliver to Charter the certifi-

cate or certificates representing the shares of PSI Common Stock listed in Section 1.1; and each certificate shall be accompanied by a blank stock power, duly endorsed for transfer, with signatures guaranteed by a national banking association or a member firm of the New York Stock Exchange. The shares of PSI Common Stock to be purchased by Charter shall be delivered to Charter at the offices of the transfer agent and registrar for the Common Stock of PSI against payment by Charter of the purchase price listed in paragraph (a) of Section 1.3. Payment shall be made, at Charters election, by certified check, official bank check, cashier's check or a wire transfer of funds; and payment shall be made to each Shareholder in an amount equal to the Section 1.3(a) purchase price per share times the number of shares listed beside such Shareholder's name in Section 1.1.

1.3. *Purchase Price.* The purchase price for the shares of PSI Common Stock to be purchased by Charter under this Agreement shall be not less than $5.00 per share payable as follows:

(a) On the Closing Date, Charter shall pay $3.50 per share for each of the 371,919 shares listed in Section 1.1

(b) Upon the effective date of any acquisition or corporate transaction (in whatever form) by Charter of PSI whereby Charter, directly or indirectly, has an equity interest (including the shares purchased pursuant hereto) in excess of 50% of the outstanding Common Stock of PSI, which event occurs on or before May 31, 1987, Charter shall promptly pay to each Shareholder an amount equal to the excess (but not less than $1.50 per share), if any,

of the per-share consideration payable to shareholders of PSI in connection with such acquisition or transaction over $3.50; and such amount per share shall be paid to each Shareholder with respect to the number of shares listed by such Shareholder's name in Section 1.1 of this Agreement.

1.4. *Taxes, etc.* Charter shall be responsible for payment of any and all applicable transfer taxes, stamp taxes, intangibles taxes and other taxes and duties owing or imposed on or as a result of the stock purchase contemplated by Section 1. Charter shall have no obligation to purchase any of the shares of PSI Common Stock pursuant to Section 1 unless Shareholders sell to Charter on the Closing Date a total of 371,919 shares.

2. *Option to Repurchase.*

2.1. *Repurchase Option.* In the event that Charter (either directly or through a subsidiary) has not consummated an acquisition or transaction with PSI as described in Section 1.3(b) on or before December 31, 1984, or Charter (either directly or through a subsidiary) has not otherwise acquired a controlling interest in PSI as described in Section 1.3(b), then each Shareholder shall individually have the option to repurchase from Charter the number of shares which Charter purchased from such Shareholder pursuant to this Agreement at a purchase price of $3.50 per share. Such option to repurchase shall be exercisable by each Shareholder individually for all but not less than all of the shares sold to Charter by such Shareholder pursuant to this Agreement and as listed in Section 1.1; and such option shall be exercisable by each Shareholder between January 1, 1985 and February 28,

1985 (except as provided below). Charter shall have the right to accelerate the beginning and ending of the 59-day option exercise period, in the event (a) Charter determines that one or more of the conditions precedent listed in Section 7.2 have not been satisfied and cannot be satisfied, and (b) as a result thereof, Charter has no intention of consummating an acquisition or other transaction with PSI whereby Charter will acquire a controlling interest in PSI [as described in Section 1.3(b)], and (c) Charter gives written notice to Shareholders describing the facts and circumstances underlying the determination described in (a) and making a representation consistent with (b), and the Shareholders within 10 days of such notice fail to cause the condition precedent to be satisfied. In the event of such acceleration, the 59-day option period shall begin ten days after the giving of such notice. In the event of such acceleration, the dates listed in Section 2.2 shall be appropriately adjusted.

2.2. *Exercise of Option to Repurchase.* The option to repurchase provided for in Section 2.1 shall be exercisable by each Shareholder by giving written notice of exercise to Charter at the address listed on the signature page of this Agreement on or after January 1, 1985 and before February 28, 1985, which notice must be actually received by Charter on or before February 28, 1985. Upon exercise of the option to repurchase by each Shareholder, by any Shareholder or by all Shareholders, the closing of the repurchase by the Shareholder or Shareholders who have exercised the option to repurchase shall occur at the offices of the transfer agent for the Common Stock of PSI ten days after receipt by Charter of the written notice

of exercise of option by each Shareholder. At such closing, Charter shall deliver to each Shareholder who exercises the option provided by Section 2.1 a certificate or certificates representing the number of shares to be repurchased by each Shareholder, which certificate or certificates shall be accompanied by a blank stock power, duly endorsed for transfer with signatures guaranteed by a national banking association or a member firm of the New York Stock Exchange. Payment shall be made to Charter, against delivery of such certificate or certificates, by, at each Shareholder's election, certified check, cashier's check or wire transfer of funds to an account designated in writing by Charter. In reselling shares to a Shareholder under this Section 2, Charter shall represent and warrant to such Shareholder that, during the period of time the shares of PSI Common Stock have been owned by Charter, Charter has not created or suffered to exist any claims, pledges, liens or encumbrances whatsoever on such shares of PSI Common Stock, except for any claims, pledges, liens or encumbrances which existed upon the transfer and sale of such shares to Charter pursuant to Section 1 of this Agreement.

3. *Covenants of Shareholders.* Shareholders, severally and not jointly, covenant and agree with Charter as follows:

3.1. The employment agreement, dated January 6, 1981, between PSI and Kenneth E. Hansen, the employment agreement, dated July 16, 1982, between PSI and Jerome S. Cardin, and the employment agreement, dated July 16, 1982, between PSI and Jerome J. Coller, M.D., and each of them, shall be terminated upon the Closing of the

Stock Purchase provided for in Section 1 of this Agreement; and upon such Closing, PSI shall have no other or further liability or obligation to Kenneth E. Hansen, Jerome S. Cardin or Jerome J. Coller, M.D. under such agreements whatsoever, except for payment of regular monthly compensation under such employment agreements, prorated through the date of Closing of the purchase by Charter of shares of PSI Common Stock pursuant to Section 1.

3.2. Shareholders, upon the Closing, release PSI from any and all liabilities or obligations of PSI to Shareholders, except as provided in Section 3.1 and except for a consulting agreement between PSI and Kenneth E. Hansen as described in Section 9.

3.3. In consideration of Charter's execution of this Agreement, each of the Shareholders agrees that, for the period commencing on the Closing Date of this Agreement and, in the case of Messrs. Cardin and Coller, ending on the first anniversary of such Closing Date and, in the case of Mr. Hansen, ending on the third anniversary of such Closing Date, he shall not, in any manner, directly or indirectly, engage in, become interested in or render services to any business entity engaged in the design or sale of computer systems for automated, interactive, psychological testing conducting operations anywhere in North America. For purposes of this Section 3.3, the phrase, "businesses conducting operations anywhere in North America," shall refer to any businesses: (a) with headquarters, offices or facilities of any type located in North America; (b) which provide services or products in North America; or (c) with any connection with or to North America.

Each of the Shareholders hereby agrees that any remedy at law for any breach of the provisions contained in this Section 3.3 shall be inadequate and that Charter shall be entitled to injunctive relief in addition to any other remedy which may be available.

If a judicial determination is made that any of the provisions of this Section 3.3 constitute an unreasonable or otherwise unenforceable restriction against the Shareholders, the provisions of this Section 3.3 shall be rendered void only to the extent that such judicial determination finds such provisions to be unreasonable or otherwise unenforceable.

3.4. Between the date of this Agreement and the earlier of December 31, 1985 or the termination or exercise of the Section 2 repurchase option, no Shareholder shall, directly or indirectly (including transactions by any member of such Shareholder's immediate family or any corporation in which such Shareholder is an officer, director or a 25% or more shareholder, or any partnership in which such Shareholder is a general partner) buy or sell, sell short, trade in options on, or sell short against the box any shares of PSI Common Stock.

4. *Board of Directors of PSI.*

Charter anticipates that it, after the Closing, will advance to PSI certain funds which are needed by PSI. As an express condition precedent to Charter's obligation to close the transactions contemplated by Section 1, upon the Closing a majority of the members of the Board of Directors of PSI shall be designees of Charter.

5. *Representations and Warranties of Shareholders.* Except as otherwise disclosed to Charter in this Agreement or in any document delivered pursuant to or in connection with this Agreement or otherwise disclosed by Shareholders or their representatives to Charter, Shareholders severally and not jointly represent and warrant to Charter as follows:

5.1. *Ownership of Capital Stock.* The authorized capital stock of PSI consists of 5,000,000 shares of $0.01 par value Common Stock, of which 1,482,267 shares are now and will be on the Closing Date issued and outstanding; and all of the issued and outstanding shares of such Common Stock are and will on the Closing Date be duly and validly issued and outstanding and fully paid and nonassessable. No other class of equity security of PSI is or will be on the Closing Date authorized or issued and outstanding. There are not and will not be on the Closing Date any outstanding warrants, options or other rights to acquire stock or other securities of PSI or Subsidiary, except for warrants to purchase an aggregate of 70,000 shares of Common Stock at prices ranging from $5.35 to $6.40 per share, which warrants were issued to certain underwriters and a finder in September 1982 in connection with PSI's initial public offering of PSI Common Stock.

5.2. *Reports.* PSI has previously delivered to Charter a true and correct copy of PSI's most recent 10-K Report, 10-Q Report, 8-K Report, and definitive proxy statement filed by PSI with the Securities and Exchange Commission. As of their respective dates, none of such document contained any untrue statement of a material fact or omitted any material fact required to be stated therein or

necessary to make the statements therein not misleading. Since December 31, 1982, PSI has filed all reports, registrations and statements and any amendments thereto which it was required to file with the Securities and Exchange Commission.

5.3 *Financial Statements and Absence of Undisclosed Liabilities.*

(a) Shareholders have delivered to Charter a true and complete copy of the audited financial statements of PSI for the year ended November 30, 1983, together with the unqualified report thereon of Alexander Grant & Company, independent certified public accountants, and the unaudited financial statements of PSI for the quarter ended February 29, 1984 (collectively referred to as the "Financial Statements," and the February 29, 1984 Balance Sheet is referred to as the "Balance Sheet"). The Financial Statements have been prepared in accordance with generally accepted accounting principles consistently applied and fairly present the financial condition of PSI as of their respective dates and the results of operations of PSI for the one year period ended November 30, 1983 and the quarter ended February 29, 1984.

(b) Except to the extent specifically reflected or specifically reserved against (which reserves are adequate in amount) in the February 29, 1984 Balance Sheet, and the accompanying Notes (if any) thereto, PSI, as of said date, had no material liabilities or obligations of any nature, whether accrued, absolute, contingent or otherwise, and whether due or to become due, including, without limitation, liabilities for income or other taxes due or to be-

come due for any period prior to February 29, 1984, or arising out of transactions entered into or any state of facts existing prior to such date, other than as specifically disclosed by this Agreement or otherwise to Charter.

(c) Since February 29, 1984, there has not been (i) any material change in the financial condition, assets, liabilities or business of PSI other than changes in the ordinary course of business, none of which (individually and in the aggregate) has been materially adverse, except for a decline in revenues and an increase in losses; (ii) any material damage, destruction or loss, whether or not covered by insurance; (iii) any sale or transfer of any asset or other transaction entered into by PSI other than in the ordinary course of business or involving any asset having a book or market value in excess of $10,000; (iv) any issuance of any options, warrants, bonds, notes, evidence of indebtedness or other securities; or (v) any material encumbrance of any asset of PSI.

(d) Except in the ordinary course of business, since February 29, 1984, PSI has not entered into any material contract, other than acceptance of routine purchase orders for products sold by PSI, and has not amended, altered or terminated any material agreement to which it is a party, except for termination by financial institutions of lines of credit or other obligations to make loans to PSI. In addition, since February 29, 1984, PSI has not created or incurred any material mortgage, lien, charge or encumbrance on, or pledge on, any of its assets, real or personal; and PSI has not increased the salary of any employee, except in the ordinary course of business, and has not paid or agreed to pay any bonus to any employee or to adopt any

new employee benefit plan, except as described in PSI's most recent proxy statement.

5.4. The Board of Directors of PSI has not adopted a resolution electing that PSI be subject to the special voting requirements of Maryland law as described on pages 9 and 10 of PSI's proxy statement dated April 4, 1984.

5.5 The litigation described in Note K of the Notes to Financial Statements of PSI for the year ended November 30, 1983, and litigation and claims otherwise disclosed to Charter, have not and will not result in awards of damages against PSI in excess of $50,000; and there is not pending or threatened against PSI any other litigation which could have a material adverse effect on PSI.

5.6. Except as otherwise provided in Section 3.3, the representations, warranties and covenants of Shareholders shall expire on the earlier of May 31, 1985 or the consummation of an acquisition transaction of the type described in Section 1.3(b).

6. *Indemnification.*

6.1. Shareholders, severally and not jointly, indemnify Charter against, and hold Charter harmless from any and all losses, damages, costs and expenses (including reasonable attorneys' fees and other legal costs and expenses) suffered by Charter resulting from, or arising in connection with, any inaccuracy or misrepresentation in, or breach of, or default in performance of or compliance with, any of the warranties, representations, covenants or agreements, made by Shareholders in this Agreement. Charter indemnifies Shareholders against, and holds Shareholders harm-

less from any and all losses, damages, costs and expenses (including reasonable attorneys' fees and other legal costs and expenses) suffered by Shareholders resulting from, or arising in connection with, any inaccuracy or misrepresentation in, or breach of, or default in performance of or compliance with, any of the warranties, representations, covenants or agreements, made by Charter in this Agreement.

6.2. Charter shall not be entitled to recover from Shareholders on any claim for indemnification under Section 6.1 to the extent that the aggregate of the losses, damages, costs and expenses suffered by Charter with respect to which they otherwise would be entitled to recover does not exceed $50,000.

6.3. Charter shall not have any right to assert any claim for indemnification under this Section 6 after the first anniversary of the Closing; provided, however, that if there shall be pending on the first anniversary of the Closing any claim for indemnification under this Section 6, the obligations of Shareholders under this Section 6 with respect to such pending claim, and the right of Charter to be indemnified under this Section 6 with respect to such pending claim, shall survive such date. Charter's indemnification of Shareholders shall survive the Closing and the consummation of an acquisition or transaction as described in Section 1.3(b).

6.4. If any event shall occur which gives Charter the right to assert a claim for indemnification under this Section 6, no loss, damage, cost or expense shall be deemed to have been suffered or incurred by Charter to the extent of any insurance proceeds or tax or other savings realized

by Charter as a result of such event, after taking into account any insurance proceeds or tax or other savings lost or to be lost, and any additional insurance premiums or other expenses or taxes to be paid, by Charter as a result of such event or in connection with any amounts paid or to be paid to Charter in satisfaction of such claim for indemnification.

6.5. An indemnifying party or parties ("indemnifying parties") shall satisfy any and all claims for indemnification asserted by an indemnified party under this Section 6 within 60 days after receipt of written notice of such claim for indemnification from such indemnified party, and, in the event such indemnifying parties do not pay such amounts timely, such indemnified party shall have the right to seek all legal and other remedies to collect such indemnification amounts, plus all costs of collecting such amounts, including, without limitation, court costs and attorneys' fees.

6.6. Upon obtaining knowledge of any claim or demand by a third party which an indemnified party has determined has given rise to, or reasonably could give rise to, a claim for indemnification under this Section 6, such indemnified party shall notify one or more indemnifying parties; as appropriate ("indemnifying parties"), of such third-party claim or demand, and such indemnifying parties shall have a reasonable time (not to exceed 30 days) after receipt of such notice to elect to defend such third-party claim or demand on behalf of such indemnified party. If such indemnifying parties elect to defend such third-party claim or demand, they may do so at their expense, and such indemnified party shall make available to such

indemnifying parties and their agents and representatives all records and other materials which reasonably are required in the defense of such third-party claim or demand and otherwise shall assist and cooperate with such indemnifying parties in the defense of such third-party claim or demand; as long as such indemnifying parties are defending such third-party claim or demand in good faith, such indemnified party shall not settle or compromise such third-party claim or demand. If such indemnifying parties elect to defend such third-party claim or demand, such indemnified party shall have the right to participate in the defense of such third-party claim or demand at its expense, subject to the right of such indemnifying parties to control the defense of such third-party claim or demand. If such indemnifying parties do not elect to defend such third-party claim or demand or do not defend such third-party claim or demand in good faith, such indemnified party shall have the right to defend such third-party claim or demand; provided, however, that (i) such indemnified party shall not have any obligation to participate in the defense of, or to defend any such third-party claim or demand, and (ii) such indemnified party's defense of, or participation in the defense of, any such third-party claim or demand shall not in any way diminish or lessen the obligations of such indemnifying parties under the provisions of indemnification set forth in this Section 6.

7. *Acquisition of PSI by Charter.*

7.1. *Recitals.* Charter and Shareholders acknowledge that, prior to the negotiation and execution of this Agreement, Charter and PSI had engaged in preliminary discussions with a view toward the possible merger of PSI

and a subsidiary of PSI, under which merger Charter would have agreed to pay to the shareholders of PSI a consideration of $5.00 per each share of PSI Common Stock issued and outstanding on the effective date of the potential merger. The merger discussions between Charter and PSI included conditions precedent to Charter's obligation to close, including a requirement on the part of Charter that the license agreement for the use by PSI of the Minnesota Multi-Phasic Inventory be extended by the licensor at least through June 30, 1987.

7.2 *Proposal of Merger.* Charter agrees that, promptly after the Closing of the transactions contemplated by this Agreement, a subsidiary of Charter and PSI shall enter into a merger agreement, whereby, subject to the conditions precedent to closing such merger described below, Charter's subsidiary would pay $5.00 per share for each share of PSI Common Stock outstanding on the effective date of the merger. Charter shall vote its shares of PSI Common Stock purchased hereunder in favor of such merger. Such merger would be subject to the following conditions precedent to Charter's obligation to close:

(a) The approval of the merger by the required number of votes of shares under Maryland law.

(b) The holders of no more than 5% of the issued and outstanding shares of PSI Common Stock shall dissent from the merger.

(c) PSI shall have obtained (and Charter shall use reasonable efforts to obtain) an extension of the MMPI license until at least June 30, 1987.

(d) No litigation or administrative proceeding shall have been instituted seeking to bar or terminate the proposed merger.

(e) Between the date hereof and the effective date of the merger, Charter shall not have discovered any fact, circumstance or condition relating specifically to the business, assets and liabilities of PSI (and not to general market conditions) which had not previously been disclosed to Charter and which is material and adverse to PSI.

8. *Press Release.* Promptly upon the execution of this Agreement, Shareholders, Charter and PSI shall jointly release to the public a press release in the form of Exhibit A attached hereto.

9. *Covenants of Charter.* Charter covenants and agrees with Shareholders as follows:

(a) PSI and Mr. Hansen shall have entered into a three-year consulting agreement whereby Mr. Hansen is to devote ten (10) weeks per year to the business of PSI as requested by PSI and shall be paid by PSI $25,000 per year.

(b) From the Closing Date under this Agreement through the last day of the Section 2 repurchase option period, Charter shall operate PSI's business in its ordinary course and shall not permit PSI to pay any dividend, pay any management or similar corporate overhead fee to Charter, pay any interest or finance fees to Charter at rates in excess of Charter's actual cost of borrowing, create any lien, mortgage, encumbrance or claim on any presently owned asset of PSI or any substitute therefor,

sell to Charter or any subsidiary or affiliate of Charter any goods or services for a price less than PSI's standard prices to unrelated customers, issue any shares of capital stock of PSI or any warrants or options to purchase any such shares, or terminate any license agreement to which PSI is a party.

10. *Miscellaneous.*

10.1. This Agreement is being made in Georgia and shall be construed and enforced in accordance with the laws of that State.

10.2. This Agreement contains the entire understanding among the parties and supersedes any prior understanding and agreements between them respecting the within subject matter. There are no representations, agreements, arrangements or understandings, oral or written, between and among the parties hereto relating to the subject matter of this Agreement which are not fully expressed herein.

10.3. All notices shall be in writing and shall be deemed to have been duly given if delivered personally or if mailed via certified mail postage prepaid to the party at his address set forth at the end of this Agreement. Any party may change said address by giving the other parties hereto notice of such change of address. Notice given as hereinabove provided shall be deemed received by the party to whom it is addressed on the third calendar day following the date on which said notice is deposited in the mail, except that actual receipt shall be required for the exercise of options pursuant to Section 2.

10.4. The waiver of a breach of any provision of this Agreement shall not operate or be construed as a waiver of any subsequent breach.

10.5. This Agreement shall inure to the benefit of and be binding upon the respective heirs, executors, administrators, successors and assigns of the parties hereto.

10.6. Section and other headings contained in this Agreement are for reference purposes only and are in no way intended to describe, interpret, define or limit the scope, extent or intent of this Agreement or any provision hereof.

10.7. Every provision of this Agreement is intended to be severable. If any term or provision hereof is illegal or invalid for any reason whatsoever, such illegality or invalidity shall not affect the validity of the remainder of this Agreement.

10.8. In the construction of this Agreement, the masculine shall include the feminine or neuter and the singular shall include the plural, in all cases where such meanings would be appropriate.

10.9. This Agreement may be executed in multiple counterparts, each of which shall be deemed an original and all of which shall constitute one agreement, and the signatures of any party to any counterpart shall be deemed to be a signature to, and may be appended to, any other counterpart.

10.10. Time is of the essence of this Agreement.

10.11. Charter shall purchase the shares of PSI Common Stock to be purchased from Shareholders pur-

suant to and in compliance with applicable provisions of the Securities Act of 1933 relating to purchases from affiliates and shall deliver at Closing an investment letter to Shareholders.

10.12. The "Closing Date" shall be and mean the earliest date after execution of this Agreement on which the parties are able to perform the acts necessary to close. If the stock purchase and director change transactions have not been closed by June 19, 1984, then any party shall have the right to terminate this Agreement, unless the failure to close by such date is due to the default or inability to close of such party.

10.13. Charter represents and warrants to Shareholders as follows:

(a) Charter has reviewed the quarterly report on Form 10-Q of PSI for the quarter ended February 29, 1984, and Charter has noted that, for such quarter, PSI had a loss of $587,471 (on an unaudited basis) and at February 29, 1984, had an accumulated deficit of $1,798,-686.

(b) Charter has reviewed unaudited, interim financial statements of PSI for the month of March 1984, which indicates that the financial condition of PSI continued to deteriorate after the quarter ended February 29, 1984, and has been informed by Shareholders that such condition has continued to deteriorate since March 1984.

(c) This Agreement has been duly authorized by all necessary corporate action on the part of Charter, and Charter has full corporate power and authority to enter into this Agreement and to perform its obligations hereunder.

10.14. Charter agrees that no Shareholder shall be obligated to Charter under Section 6 or otherwise in respect of this Agreement in an amount in excess of the purchase price paid to such Shareholder by Charter hereunder.

IN WITNESS WHEREOF, the parties, intending to be legally bound, have executed this Agreement, as of the date first written above.

CHARTER MEDICAL CORPORATION

Date 6/8/84

By: /s/ Robert P. Porter
Title: Vice President

577 Mulberry Street
Macon, Georgia 31298

SHAREHOLDERS

Date 6/8/84

/s/ Jerome S. Cardin
Jerome S. Cardin
6615 Reisterstown Road
Baltimore, Maryland 21215

Date

Jerome J. Coller, M.D.
600 Reisterstown Road
Baltimore, Maryland 21215

Date 6/8/84

/s/ Kenneth E. Hansen
Kenneth E. Hansen
2115 Chapel Valley Lane
Timonium, Maryland 21093

EXHIBIT A

Charter Medical Corporation (AMEX) announced today that it has entered into an agreement with three directors and officers of Psych Systems, Inc. (OTC) to purchase 371,919 shares of PSI Common Stock from the three directors and officers (approximately 25.1% of the outstanding shares of PSI Common Stock). The initial purchase price is $3.50 per share, but shall be increased to an amount equal to the per share price paid by Charter upon any subsequent acquisition of PSI by Charter.

Charter has agreed promptly to enter into a merger agreement between PSI and a subsidiary of Charter. In the merger, Charter would pay $5.00 per share for the outstanding shares of PSI Common Stock. Closing of the merger would be subject to certain conditions, including approval by PSI Shareholders.

Charter representatives will be appointed to the Board of Directors of PSI and will constitute a majority of PSI's Board.

Supreme Court, U.S.
FILED
NOV 9 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-657

In The

Supreme Court of the United States

October Term, 1988

CHARTER MEDICAL CORPORATION,

Petitioner,

vs.

JEROME S. CARDIN, JEROME J. COLLER, M.D. and KENNETH E. HANSEN,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

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RESPONDENTS' BRIEF IN OPPOSITION

The respondents, Jerome S. Cardin, Jerome J. Coller and Kenneth E. Hansen, respectfully request that this Court deny the petition for writ of certiorari, seeking review of the Fourth Circuit's opinion and judgment in this case. The Fourth Circuit's opinion is unreported but is found at App. 28-37 in the Appendix filed with the petition.

STATEMENT OF THE CASE

Charter Medical Corp. ("Charter") adduced no evidence whatsoever that Messrs. Cardin, Coller and Hansen ("CCH") misrepresented any fact in connection with the sale of their stock to Charter on June 11, 1984. Charter's presentation rested solely on alleged omission—in effect, with the hindsight knowledge that the stock purchase was improvident, Charter sought to uncover some assertedly non-disclosed fact which it could argue was "material." The alleged omissions related to events occurring in late 1983 and early 1984, well before Charter commenced serious evaluation of whether it wished to purchase CCH's stock. It was proven, in Charter's case-in-chief, that the financial performance of Psych Systems, Inc. ("PSI") was catastrophic, getting worse, was fully disclosed to Charter, and was immaterial to its purchase decision. App. 10-11.

Charter, in hindsight, now latches onto the alleged dishonesty of management as the material fact which should have been disclosed to it. It is true that there was a scheme to inflate PSI's sales at fiscal yearend 1983, but it is also true that the outside auditors had caught the scheme and reversed out the sales that should not have been taken into income. Further, as a result of the auditors' recommendation, the chief financial officer was promptly discharged in early 1984 and his personal role, if any, in the scheme to inflate sales was thereafter of no arguable interest.

Charter's argument is that Mr. Moskowitz, PSI's president, was involved in the sales scheme, that CCH discovered his personal involvement, and that they should have disclosed his involvement to Charter prior to its stock purchase. The evidence, however, does not sustain

Charter's position that CCH knew of Mr. Moskowitz's involvement, if he was involved.

The lead auditor, Mr. Krosin, testified that his accounting firm, Alexander Grant & Co. (AG&Co.), developed no evidence that Mr. Moskowitz was involved in any wrongdoing: "We have not heard any tangible—or we did not have any tangible evidence either oral or written that had indicated that Mr. Moskowitz had been directly involved in any of these matters." Tr. 2931 (Krosin). Mr. Krosin testified that he recommended that Mr. Moskowitz's employment be terminated, but that recommendation was made "as a result of his position and that Mr. Wilowatyj was under his direction, that he may very well have been involved . . . ." Tr. 2931 (Krosin). However, PSI's Board of Directors (effectively CCH) was under no obligation to terminate Mr. Moskowitz in the absence of evidence of wrongdoing on his part.

Charter asserts that CCH had independent knowledge of Mr. Moskowitz's (alleged) wrongdoing, but this statement is not correct. Charter relies on hearsay information that came to Dr. Coller's attention. Petition, p. 5. However, Dr. Coller testified that he was unable to confirm the hearsay comments adverse to Mr. Moskowitz, and indeed the hearsay statements appearing in the first sentence of the block quotation on p. 5 of Charter s petition were not even offered by Charter for truth of fact. Tr. 2662-65 (Coller).[1]

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[1] There was much discussion about Dr. Coller's March 4 memorandum at trial. The trial court admitted the document subject to its evaluation as to weight. Tr. 2665 (The Court). The trial court in its opinion did not specifically discuss the memorandum no doubt due to the unconfirmed hearsay in it.

Further, after March 4, Mr. Moskowitz showed that the concerns about his integrity were misplaced. "[W]e found nothing subsequent that would indicate that there was a problem with Moskowitz's credibility. It seemed that whatever our concerns were at the time of March 4th were not borne out later." Tr. 2668-69 (Coller). Thus, even if CCH indicated to AG&Co. that they would eventually replace Mr. Moskowitz, as the trial court found (App. 17), they in their minds felt that retention of Mr. Moskowitz was in PSI's best interest, and there is no evidence that they were thinking about replacing him in the spring of 1984, in the period (April, May) prior to the sale of their stock to Charter.

Factually, then, CCH did not have credible information that Mr. Moskowitz was personally involved in wrongdoing, and, it follows, could not in any event have disclosed to Charter what they themselves did not know.

———o———

REASONS FOR DENYING THE WRIT

1. Charter's "Question Presented" assumes that the controlling shareholders knew that the corporation's president participated in a scheme to inflate sales and falsify the corporation's financial statements. The record, however, shows that they did not have probative knowledge to this effect. The courts below did not address the question as framed by Charter because the evidence did not rquire that the issue be directly addressed. This Court should not entertain an issue not fairly presented by the evidence and not directly addressed by the courts below.

2. CCH's lack of knowledge of Mr. Moskowitz's (alleged) personal involvement in the sales scheme, especially after the auditors found no evidence of his involvement despite an extended audit, of necessity gives rise to a complete defense in CCH under § 12(2) of the Securities Act, 15 U.S.C. § 771(2). See App. 35-36. The sellers insisted on an extended audit to make sure that the yearend statements were not tainted by the sales scheme, the auditors did not advise that Mr. Moskowitz was personally involved in wrongdoing, and in this circumstance the sellers in the exercise of reasonable care could not have known of his (alleged) involvement. This Court should not entertain a petition where it is obvious that the sellers have a complete defense to the claim presented by the petition. In this connection, the sellers never put on their defense under § 12(2) because the trial court entered judgment in their favor at the conclusion of Charter's case, under Rule 41(b), Fed. R. Civ. P.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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(202) 331-5022

Attorney for Respondents